The New York

Certified Public Accountant

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Independent Audit of New York State Villages

Cost of Producing Crude Petroleum

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Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public, to protect the interest of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects, and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—From the Certificate of Incorporation.

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BOOK REVIEWS

Consolidated Financial Statements

By William Herbert Childs. CORNELL UNIVERSITY PRESS, Ithaca, New York, 1949. Pages: xv + 352; $5.00.

This scholarly work of 352 pages, including appendix, bibliography and index, is an effort, in the words of the author, "(1) to present and weigh conflicting basic concepts; (2) to explore important but neglected topics; (3) to reach some reasonable conclusions on the subject of consolidation accounting and consolidated statements."

The author's approach is that of the theorist working out a logical basis upon which the practitioner may build his detailed handling of consolidations. He starts by defining his terms, giving a history of the use and thought with respect to consolidations, explaining the basic mechanics involved and giving the pros and cons involved in the decision as to whether consolidation should be based on the "financial unit" or on the "operational unit." A discussion of some of the practical aspects of the basic concepts precedes chapters devoted to the technical divisions of the problems, which in turn are followed by the author's conclusions and recommendations.

The author has not only checked the Securities and Exchange Commission's rulings as well as the Treasury Department's regulations and the literature on the subject, but has also been fortunate in obtaining the answers to a questionnaire from seventeen leading accountants affiliated with public accounting firms, universities, the Government. and private industrial organizations. In addition he has made a survey of the preparations of consolidated statements by some large concerns. All of this assists him in his analysis.

He does not, however, feel himself bound to agree with either the views of the experts, of the SEC, or, as we are so prone to do, of the Treasury Department. The result is a work to which the SEC and the Treasury Department might give some thought in the promulgation of their regulations with respect to consolidated financial statements. It goes without saying that practitioners would do well to consider the points made by Dr. Childs.

The book is well worth a thoughtful reading (and re-reading, if necessary) by all students of the problem of consolidations, and anyone who prepares consolidated statements should be included in that category. College and university students might find it a bit inadequate unless supplemented by more illustrations of the problems involved, and by further work based on the fundamentals so clearly presented in this volume. All in all, we have here a very valuable contribution to the literature on consolidated statements for which the profession owes a debt of gratitude to Professor Childs.

RALPH G. LEDLEY

Elementary College Accounting

By Paul R. Jackson. PRENTICE-HALL, INC., New York, N. Y., 1949. Pages: vii + 303; $3.60.

Elementary College Accounting is offered as a text designed particularly for students taking their first course in accounting. It presumably is intended for students who have had no previous bookkeeping course. The author claims it is unique in that it contains "every principle and procedure required to keep an ordinary set of accounting records," something, so he states, which is lacking in every other text in elementary accounting on the market today.

In the first three chapters of the text, the complete accounting cycle is covered. Principles of debit and credit are explained and applied to asset, liability, income and expense accounts in the first two chapters; and the two column journal, posting to ledger, trial balance, simple financial statements, closing procedure, and post-closing trial balance are covered in Chapter 3. Subsequent chapters deal with special journals, pay roll accounting, business papers, negotiable instruments, adjustments, the work sheet, and financial statements.

While the general plan of the book is good, too much stress is laid on the mechanical features of bookkeeping and not enough on basic accounting principles, a sound knowledge of which is essential to the student of accounting. The treatment of most topics is, in the main, hurried. There is need for a much more complete discussion of the operation of controlling accounts. The presentation of the adjusting and closing procedure in Chapter 14 is too meager. Forms of journals and accounts are presented without sufficient explanation.

The discussion of vouchers in Chapter 4, pay-roll accounting in Chapter 9, and notes, drafts and trade acceptances in Chapter 10, are the strongest parts of this volume. This book would appear to be better suited for the junior business college than as a basic text in college accounting.

LEON MARLOWE

New York, N. Y.

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Book Reviews

(Continued from page 724)

Your Social Security

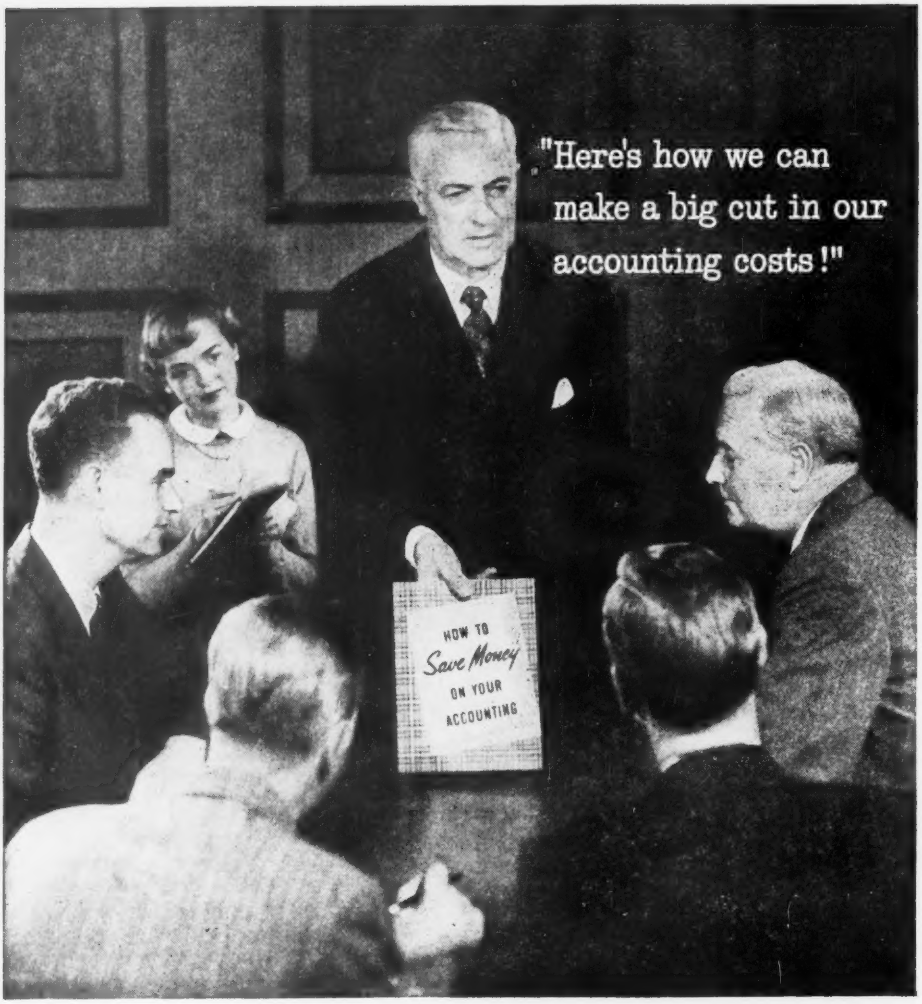
By J. K. Lasser. Simon and Schuster, New York, N. Y., 1949. Pages: vii + 120; $1.00.

There are 75 million people in the United States who have established Social Security accounts. Most of them are woefully ignorant of the benefits due them, as well as the pitfalls to be avoided so as not to lose these benefits.

This book is written for them in the typically clear and incisive style of a Lasser publication. It includes the following sections:

I. Introduction to Social Security.
II. How to Understand the Language of Social Security.
III. Answers to Questions Most Frequently Asked About Social Security.
IV. How to Get the Most Out of Your Social Security.
V. How to Get the Most Out of Your Life Insurance if You are Under Social Security.
VI. How to Use "E" Bonds to Supplement Your Social Security.
VII. Where to File Your Social Security Claim.
VIII. How and When to File for Social Security Benefits.
IX. Records to Help You Prove Your Benefits.
X. What to Do if Your Social Security Tax Has Been Overpaid.
XI. What Veterans Should Know About Special Social Security Benefits.
XII. The Employer's Responsibility Under Social Security.

This reviewer found the text very easy to understand and follow. It should answer virtually every question likely to arise. It is a big dollar's worth.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Independent Audit of New York State Villages

By GEORGE W. LAFFERTY, C.P.A.

Introduction

THE objectives of this article are twofold, first, to point out the value of an independent audit to New York State Villages, and secondly, which is the more important, to outline their major auditing problems and related audit steps.

New York State laws provide for an audit of the records of the Village treasurer as follows: ". . . the board of trustees shall audit or cause to be audited, and determine the correctness of such reports (the treasurer's reports) and for that purpose may hire and pay an accountant to make such audit . . ." (McKinney's Consolidated Laws of New York, Annotated, Book 63, Village Law; Article 4, paragraph 81). Although the law does not state whether the audit shall be annual, quarterly, or monthly, arrangements for audit appear to be within the discretion of Village officials.

The writer believes a most satisfactory basis for Village audits to be monthly or quarterly examinations and reports followed by a long-form report at the year end. This belief is entertained because of the volume of detail involved in such audits. A superior job of auditing can be done on an interim basis with better audit services resulting for the Village.

GEORGE W. LAFFERTY, C.P.A. (Texas), is a senior accountant associated with the firm of Frazer and Torbet, C.P.A's. He was formerly an Instructor of Business Administration at the University of Texas (1939-1941); Assistant State Auditor, State of Texas (1941-1942); Deck Officer, U. S. Navy (1942-1946); and Associate Professor of Accounting, University of Alabama (1946-1948).

Dr. Lafferty earned the degrees of B.S. at the American International College (1938), M.B.A. at the Wharton School of the University of Pennsylvania (1939), and Ph.D. at the University of Texas (1948).

He has written other articles for The Accounting Review and the NACA Bulletin.

Limitation of Article Content

The material content of this article is limited to interim examinations conducted on a monthly or quarterly basis. Reference will be made, however, to those major points of audit investigation which are applicable only at the year-end and to the accumulation of information, at interim examinations, for later presentation in the year-end report.

Need for Independent Audit Services

Every audit, governmental or private, should result in the rendition of services to the client which fulfill the client's needs. There are listed below some of the services that the independ-

ent auditor can provide for Villages of this state.

1. Independent report on stewardship of Village officials.
2. Improvement of Village financial controls.
3. Aid in the observance of State and local legal requirements in the accounting procedures of the Village.
4. Increased clarity in the reporting of financial activities.
5. Assistance in the preparation of financial reports required by the State Department of Audit and Control.
6. Detection of errors of omission and commission in the accounting records.
7. Savings to taxpayers through correct interpretation of financial factors in connection with determination of tax rates.

In addition to the above, some more tangible financial benefits that may be realized by Villages are: (1) improved credit status from certified financial statements; (2) lower cost of surety bonds (bonding companies will allow a discount on surety bonds if records are audited by certified public accountants); (3) protection against misappropriation of Village funds; and (4) reduced operating costs through elimination of inefficiencies, where observed.

The balance of this article is devoted to stating some of the major audit problems in New York State Villages and a discussion of how they may be resolved. They are broadly classified into two groups; cash receipts and cash disbursements. The above classification will not be adhered to strictly as other factors will, of a necessity, have to be introduced. However, it will serve to control the presentation of material as the villages operate mainly on a cash receipts and disbursements basis.

Cash Receipts

Cash Receipts from Revenues and Other Sources

By far the greater portion of cash receipts flow through officials such as the village Clerk, Engineer, Building Inspector and Tax Receiver to the Treasurer for deposit and recording. The last named official maintains the basic accounting records of the Village which include the cash book, the general ledger, the detailed appropriation ledger and the detailed revenue ledger. In some villages the treasurer's administrative duties are delegated to an assistant treasurer who keeps the financial records.

Ad-Valorem Taxes on Real Estate

These taxes are levied on real estate in accordance with its assessed valuation. The tax rate is determined from the relationship between budgeted expenditures, after deducting amounts provided from surplus and other sources, and assessed valuation of real estate in the village subject to taxation.

The assessed values of individual properties are then extended by the tax rate to determine the amounts due from each property owner. The computation of the tax for individual properties is a legal duty of the Board of Trustees and is ordinarily delegated to the Village Clerk. Upon determination of taxes due, the tax roll accompanied by a warrant for collection, is forwarded to the tax receiver. Tax collections are made in two installments, June and December. Audit problems connected with real estate taxes are listed as follows:

1. Verification of tax assessments.
2. Determination that money collected has been deposited to the credit of the Village by the tax receiver.
3. Ascertainment that collections have been applied to credit of taxpayer on assessment rolls.
4. Proof that amounts represented as uncollected taxes on the Village records at the year-end also appear on the tax rolls.
5. Verification of tax collections and cancellations as applicable to tax arrears prior to the current year.
6. Verification that interest and penalties on current taxes and tax arrears have been accurately computed.
7. Sale of tax liens and redemptions.
8. Year-end valuation of tax arrears.

Verification of Tax Assessments: Ascertain tax rate; calculate rate independently by dividing total assessed values subject to tax by budgeted expenditures net of funds provided by surplus and other sources. Apply tax rate to individual assessed values subject to tax. This may be done on a test basis to be expanded as found necessary.

Deposit of Money Collected and Credit to Taxpayer's Account on Assessment Roll: Cash as collected on account of taxes is entered in the tax receiver's cash book and a copy of the tax bill is filed as a receipt. The receipt copy may or may not have a separate number stamped on it at the time payment is made. Where this practice is followed audit work is substantially reduced. (In some villages the receipted tax bill may not be available, which increases the difficulties in proving collections.) The receiver deposits cash collected to the credit of the village and retains a duplicate deposit slip to which recorded deposits may be traced. In some cases a triplicate is prepared and forwarded to the Village Treasurer along with the receiver's report of cash collections. The receiver's report is classified according to: (1) Current Taxes, (2) Collections on Tax Arrears, (3) Interest and Penalties on Current Taxes, (4) Interest and Penalties on Tax Arrears, (5) Tax Lien Redemptions and (6) Interest and Penalties on Tax Lien Redemptions. Cash book totals are accumulated to agree with the reports made to the Treasurer.

In order to prove that money collected has been deposited to the credit of the village it will be necessary to trace amounts shown by receipted tax bills (if available) to the receiver's cash book and to prepare a summary schedule of cash collections. The schedule should reflect the report number and the total collections from each source shown by the reports. The amounts reflected in this schedule should agree with amounts deposited in the bank.

Ascertainment that Receipts have been Credited to the Individual Taxpayer's Account: This may be combined with the same operation that traces tax receipts to the receiver's cash book. Combination of these operations is effected by tracing individual receipts to the assessment roll at the same time they are traced to the receiver's cash record. In carrying out this operation agreement should be observed of: (1) amount of tax assessed and recorded as paid, (2) section, block, and lot number, and name of taxpayer as they appear on the assessment roll and the receipted bill, and (3) receipt number on roll and cash record.

If tax receipts evidencing collection are not available there is no positive proof as to what should have been recorded as collected other than the receiver's cash record and the assessment roll. In such cases the auditor's letter should indicate this weakness in internal check and control and resultant inability to prove tax collections.

There is a publicity factor which operates as a deterrent to misappropriation of tax collections. It is a legal requirement that all uncollected taxes be published at least three weeks before their sale as liens. At the year end these published lists should be agreed to the outstanding tax items of the current year, as they are reflected on the tax roll.

The operations outlined above may be executed on the basis of a test-check if sufficient faith exists in the mechanisms of internal check and control. A possible sample of one item in five is suggested, to be expanded as necessary.

Upon completion of the above steps the amounts collected, as scheduled from the receiver's cash book, should be agreed with the records of the Village Treasurer.

Proof of Uncollected Taxes—Current year: Except by direct confirmation with taxpayers, no positive proof of uncollected taxes can be established. In the absence of direct confirmation, agreement of tax rolls to published

notice of tax lien sales provides the best available evidence that items represented as uncollected actually are outstanding at the end of the tax year.

Confirmation of taxes receivable, while theoretically desirable, is not always practicable of accomplishment. Several factors operate against successful confirmation; these are: (1) taxpayer indifference, (2) political nature of tax receiver's office and (3) human tendency, on part of taxpayers, towards committing themselves on a liability item. If confirmations are dispatched, the negative type is recommended for use, except in those instances where audit investigation has revealed questionable factors that make the positive form mandatory.

One step which is considered a "must" in verifying uncollected taxes is reconcilement of outstanding items per tax roll to amounts reflected on village records. This is not identical with tracing outstanding items to the published notice of tax liens, as collections may have been made subsequent to publication and all of the liens are normally not sold.

Verification of Tax Arrears' Collections and Cancellations of Prior Years: The verification of outstanding balances of tax arrears, prior to the current year, is limited to the determination of the agreement of village records with the recorded arrears as carried on the tax arrears roll. This proof may be accomplished by scheduling the tax arrears, from the arrears rolls, classified according to year of levy. If the tax receiver prepares reconcilements with the village records the work involved in this operation may be reduced to a test-check of the receiver's work. Agreement of Village records to the receiver's rolls need be done by the auditor only once a year. If the receiver's reconciliation is accomplished at a date different than the end of the fiscal year, then the auditor must apply any changes subsequent to the date of the receiver's reconcilements to the balances at that date, thereby working to year-end balances.

There are two factors which cause changes in tax arrears accounts. These are: (1) reduction through payments of arrears by taxpayers and (2) cancellations of arrears by the Village Board of Trustees. It is recommended that the audit workpapers be so arranged as to show (1) opening balances for each year of arrears, (2) collections and cancellations applicable to each year for each month or quarter examined and (3) balance of tax arrears classified by years at end of audit period. This schedule should be prepared from the tax receiver's records and agreed to Village records at each audit date.

At the time of each periodic examination, payments of tax arrears should be traced to the tax rolls and ascertainment made that the proper section, lot and block of property has been credited with the payment; in addition any taxes cancelled should be traced to the minutes of the meeting of the Village Board in order that authority for cancellation may be verified. Such cancellations should also be traced to the tax arrears roll. In completing these verifications the auditor should be alert to situations where payments have been credited to later year's taxes and prior years remain open. Conditions of this latter sort will call for more extensive investigations in order to ascertain the reason. It should be noted that it is a not uncommon practice to apply payments on tax arrears as far as they will go to make up the amounts due and then to cancel the balance of taxes due by resolution of Village Board. Instances of this kind occur primarily where title to the property is taken by the village through foreclosure proceedings and the property is subsequently sold to private individuals or corporations.

Verification of Correctness of Interest and Penalty Computations: When examining payments on tax arrears the auditor should also take measures to ascertain that interest and penalties

have been correctly determined. Penalties are assessed at a flat 2% and interest is figured on the basis of 1% for each month past the due date. The tax bill contains full particulars as to penalties and interest and the date from which they apply.

Sale of Tax Liens and Redemptions: The date at which tax liens are sold will vary with the fiscal year of the village. The sale of tax liens involves the transfer, for consideration, by the Village of its rights to receive taxes and interest and penalties thereon to a private individual or corporation. After advertisement of tax liens they are sold, at public auction, at the lowest bid rate of interest or, in any case, not to exceed 12 percentum per annum.* Upon sale a tax lien certificate is made out and retained on file in the receiver's office.

The auditor should on a test basis, at a minimum, examine tax lien certificates on hand and ascertain that the amounts received are in agreement with the amounts due per tax arrears rolls, and that the lien has been entered on the tax arrears roll. It should also be determined that the money collected has been deposited to credit of the Village and applied to the tax year arrears represented by the lien sold.

It is common practice to handle tax lien redemptions through the Village tax receiver. The taxpayer will pay the money over to the Village receiver who, in turn, will deposit the money to the credit of the Village. Then a check will be drawn to the order of the lien holder and satisfaction of the lien noted on the face of the tax lien certificate. In addition the satisfaction of the lien will be recorded on the tax arrears roll.

Steps to verify tax lien redemptions will involve examination of the cancelled lien, agreement of the amount received with the recorded cash and ascertainment that the lien satisfaction has been entered in the tax arrears roll against the property concerned. The auditor should also determine that interest calculations have been correctly made. The interest paid will depend upon the interest rate bid at time of purchase and the time that has passed since sale of the lien. It is a common practice to allow the lien holder an extra month's interest at time of satisfaction.

Year-End Valuation of Tax Arrears: A problem which the auditor should give serious consideration to is the actual realizable worth of tax arrears as recorded in the Village books at the year-end. A valuation reserve for tax arrears collections is not practicable as a tax burden may be placed on other property owners. However, the desired results may be attained by segregating current surplus to the extent to which it is represented by tax arrears of little or no apparent worth. It is not considered wise to advise the cancellation of tax arrears as, once done, the cancelled taxes disappear from Village accounts. An exception may exist in the case of properties which are permanently tax exempt and on which arrears are outstanding.

An analysis of tax arrears, by years, arranged by section, block and lot and owner of the property, as at the year-end, provides the starting point from which to value taxes of prior years. Some of the factors which have a bearing on the value of the arrears are: (1) location, (2) zoning restrictions, (3) size of lot and (4) ownership.

Of these factors, the last one, ownership, demands some explanation. If the property is owned by a private individual, or corporation, ultimate collection is usually more likely than in the case of property owned by the Village or by the Town in which the Village is located. It is not unusual to find a great deal of property owned by the Town on exempt tax rolls, and for the Village to have a tax arrears interest

* Westchester County Law.—McKinney's Consolidated Laws of New York, Book 63, Village Law, Para. 130. Other counties are covered under Para. 126d of the Village Law, which stipulates a flat 12 percent interest rate.

in these properties. In such cases, the worth of the arrears is dependent upon the ability of the Town to sell the property and to realize the full amount due. Some judgment as to the worth of these tax arrears may be derived from a consideration of the past sales picture, the determination of amounts realized from such sales and the percent of total tax arrears realized thereon. From this study a factor for evaluation of potential collections from sale of town and/or village owned property may be arrived at.

Revenues from Sources other than Ad-Valorem Real Estate Taxes

There are numerous other revenue resources of New York State Villages. For the most part they consist of miscellaneous self-assessed taxes, licenses and permits, and state and county distributions to the Villages. There is provided below a partial list of these revenue resources.

1. Police Court Fines and Fees.
2. Parking Meter Receipts.
3. Licenses and Permits under Village Ordinance.
4. Share of Licenses and Permits under State Law.
5. Per Capita Assistance for Aid of Local Government.
6. Dog Taxes.
7. Corporation Franchise Taxes.
8. Mortgage Taxes.

It is desired to note that there has been omitted from the above list certain revenues ordinarily found under the heading of revenues other than real estate taxes. Omitted are interest and penalties on current taxes and tax arrears. Reference was made to these revenues under the section on Ad-Valorem Taxes on Real Estate. Also omitted are receipts applicable to current appropriation which will be discussed as a sub-section under appropriation expenditures.

Police Court Fines and Fees: Revenue from Police Court Fines and Fees depends upon the extent of law violations, and does not come direct to the Village. The State requires that the Village Police Justice submit a monthly report of fines and fees classified according to type of violation; e.g., Civil, Criminal and Village Code violations. This report accompanied by the fees received is submitted to the Village clerk who, in turn, remits to the State. At the end of each quarter the State remits these fines and fees to the Village, at which time they become revenue of the Village. It is to be noted that remittances, from the State, are accompanied by a statement as to month of collection and amounts applicable to criminal, civil and violations of Village codes. If there is a Village Police Pension Fund, Village violations are applicable to that fund and should not be taken into Village revenues. It should be observed further that remittances *from* the state are often in excess of the original amounts remitted *by* the Village. This is attributable to costs in connection with violations which originate in a Village, but are tried in some other legal jurisdiction and the related fines and fees remitted to the state by that jurisdiction.

In verification of these revenue sources the auditor should so arrange his workpapers that he can schedule amounts reported monthly by the Police Justice to the Village clerk and, in the same schedule, record remittances from the State when received. The amounts per monthly reports should then be agreed with the amounts received from the State. This schedule should provide for classification according to: (1) Civil fees, (2) Criminal Fines and Fees and (3) Fines and Fees applicable to Village ordinances. Any items applicable to Police Pension Funds should be so segregated and their transfer to the fund verified.

The information as scheduled in this section of the working papers should be agreed with the reports submitted by the Police Justice and the reports accompanying State remittances. Further verification may be obtained by relating the reports of the Police Justice to the Dockets of the Village Court and to records maintained by the Chief of Police. This latter step should be

carried out once or twice annually as a means of verifying the accuracy with which reports to the state are prepared.

Parking Meter Receipts: Internal control over parking meter receipts is usually weak. Collections from parking meters are made by members of the police force, and complete accountability for their remittance to the Village Treasurer is difficult to establish. To a large extent the auditor is forced to rely upon reports submitted by the Chief of Police. If practicable, it is suggested that the auditor make the rounds with collecting officers once or twice a year in order to provide a moral deterrent to misappropriation of such funds.

The auditor should recommend, if not already in existence, the provision of surety bonds on persons making parking meter collections and the limitation of collections to responsible persons on the police force. One method of meeting this problem is to have the collecting officers accompanied by a member of the Village administrative force when collections are made, and the establishment of a custodian for the parking meter keys from other than police department personnel.

Under the very best of conditions, collections from parking meters are susceptible of minor defalcations, and the auditor must exercise all his ingenuity and abilities toward the verification of receipts of this nature.

Licenses and Permits Issued by Village: Licenses and permits may be issued by the Village Engineer, Village Building Inspector and/or the Village Clerk. Typical of licenses and permits issued by these officers are electricians' licenses, plumbers' licenses, amusement licenses, restaurant licenses, street opening permits, peddlers' licenses, and sign permits.

Frequently internal control over these items is partial or completely lacking. In some instances the only evidence of a license or permit issued is a typewritten sheet or a memorandum record of licenses and permits issued without duplicates or stubs to substantiate the record.

Regardless of the degree of internal control, basic procedure requires that a control schedule be prepared on a monthly or quarterly basis, as the audit period may be. Such a schedule should be so constructed as to provide for the inclusion of data from all audits performed within a fiscal year on a single schedule. The schedules should reflect type of license or permit, numbers and quantity of licenses or permits issued, amount charged per license, dollar value of each group and total for all groups.

The quantities, and numbers of licenses and permits should be agreed to best evidence available such as, stub books, duplicates, memorandum records or whatever other data may support them. Wherever pre-numbered licenses are in use accountability for all numbers should be established. Amounts charged per license or permit may be verified to Village ordinances, although such a step ordinarily need not be carried out more than once a year.

Upon completion of the detail work in verifying licenses and permits the amounts, as verified, are compared to amounts reflected for each license group by the Village records.

Village Share of Licenses Under State Law: It will be found that from good to excellent control exists over revenues from this source. The State provides pre-numbered licenses for which the Village is accountable. Charges are established by State law and the Village is required to submit a monthly report to the State as to licenses received, licenses issued, and licenses remaining on hand. These reports taken in conjunction with the license books provide the source of verification for revenues received from this source.

Licenses falling within the above category are: (1) Dog licenses, (2) Hunting licenses, (3) Fishing licenses, (4) Hunting and Fishing licenses, (5) Deer licenses and (6) sundry other li-

censes. Upon the sale of such licenses the Village retains a share and remits the balance to the state; e.g., in the case of Hunting Licenses and Hunting and Fishing Licenses the Village retained portion is 25¢. The amount retained will vary with the type of license and the fee charged. It may be determined from the license forms.

The auditor should prepare a schedule, similar to the one described for Village licenses and permits, which will permit, at his periodic examinations, the cumulative summarization of revenues of this class as well as accountability by numerical sequence and monetary value for licenses sold. All license stubs should be examined and the numerical sequences agreed to those reported by the issuing official. Monetary values as finally verified should then be agreed to the amounts recorded in the Village books by the treasurer.

Per Capita Assistance for Aid of Local Government; Dog Taxes; Corporation Franchise Taxes; and Mortgage Taxes: All these items of revenue have a similar characteristic as regards verification. They are distributed to the Village by the State through the county Commissioner of Finance. It will often be found that there is no evidence available to the auditor other than the recorded amount of cash received. For full determination of these amounts it may be necessary to visit and consult with county offices. All of these items are distributed by formula at State direction, e.g., Per Capita Assistance for Aid of Local Government is distributed under the Moore Act on the basis of $6.75 to Counties, $3.55 to Towns and $3.00 to Villages. Attention should be called to the fact that this formula does not apply in its outlined form to Villages in Westchester County. In Westchester County, Towns share in the Village $3.00 on the basis of assessed valuation and population. The other items are distributed under formulas which are too complex for presentation in this article. Complete information as to their computation is available in the State legal code and at the office of the county commissioner of finance.

Cash Receipts other than Revenues

For the most part, cash receipts from other than revenue sources arise from the sale of bonds and the issuance of temporary certificates of indebtedness. Their verification is relatively simple, being made from bond resolutions and advices of proceeds from the banking institution handling the issue in case of bonds and in the case of temporary certificates of indebtedness from the notes themselves as related to charges recorded in the Cash Book. Agreement of par or face values is made to board minutes authorizing the issuance of the indebtedness.

Cash Disbursements

Expenditures from Appropriations

The largest dollar volume of expenditures in New York State Villages is made through the medium of appropriation expenditures. Such amounts represent expenditures as anticipated and outlined in the annual budget to be financed from current revenues. An appropriation ledger is maintained in which the amount authorized for each purpose is entered in detail and from which expenditures are deducted as incurred so as to keep Village officials currently informed as to the unexpended balance of authorized amounts. Included among appropriation expenditures are such items as salaries, operating supplies, debt retirement and capital assets financed from current tax proceeds.

The auditor's responsibilities in respect to appropriation expenditures are (1) determination that expenditures have been charged to the proper appropriation account in the detailed appropriation ledger, (2) that appropriation balances are not expended in excess of original budget, except upon authorization by the Village Board, and (3) that expenditures have been authorized by the proper officials. The last-named responsibility is common to all

Village expenditures whether charged to appropriations or other accounts.

Closely related to, and an integral part of, verifying the distribution of appropriations expenditures is the process of vouching these expenditures. It will be necessary to obtain all vouchers and ascertain (1) that they have been approved by the board of trustees, are approved by division heads and bear the signature of the Village Clerk, (2) that the distribution on the voucher jacket is supported by invoices attached, (3) that the affidavit, which is an integral part of the claim voucher, has been properly filled out and notarized and (4) that the distribution on the voucher jacket has been posted to the correct account or accounts in the appropriation ledger. Through the process of vouching, as outlined above, distribution may be verified as well as ascertainment that the voucher has been properly authorized and is in correct legal form.

It is not usual to find procedures for encumbering purchase orders in Village financial administration. That the requirement by law of such a procedure would be beneficial in the prevention of overexpenditure of appropriations goes without saying. However, until the enactment of such a statute, the auditor can only suggest such a procedure as being wise financial administration and recommend its adoption to provide better control over budgetary activities.

Normal practice is to maintain a general ledger control account for all appropriations to which is charged expenditures during the year and to which is credited receipts applicable to appropriations and any refunds of expenditures. At the end of any month the sum of unexpended balances in the appropriation detail ledger should agree with the unexpended balance as reflected in the appropriation control account. Determination of their agreement should be a standard step in the examination of appropriation expenditures. If a trial balance of the appropriation ledger is available it will be a simple matter to determine its accuracy after having vouched expenditures.

Appropriation Receipts

Quite frequently money is received by the Village representing a return of expenditures originally charged to appropriations. Examples of such items are to be found in payments received for work done by Village labor, reimbursement from State Insurance Fund for disabled workmen whose salaries have been paid by the Village, and money collected for telephone calls included in the regular monthly bill. Audit steps should trace such credits to the best evidence available and ascertain that the proper appropriation detail account has been credited.

Another type of appropriation receipt is found in the instance of library fines and fees. These amounts are available for expenditure in addition to the regularly authorized appropriation and are to be credited to the library appropriation account. Evidence of such receipts is usually found in reports by the librarian. These reports should be examined and agreed to recorded amounts as shown on the Village books. It is considered advisable that once or twice a year an examination be made of records maintained by the librarian and recorded receipts from fines and fees be agreed with those shown by reports to the Village treasurer.

A final important point in connection with appropriation receipts is that they should be set forth separately as cash receipts (exclusive of expenditure refunds), and not reflected as a reduction of amounts expended. The latter procedure results in an understatement of appropriation expenditures.

Disbursements Other than Appropriation Expenditures

The specific classifications of such disbursements are far too numerous to list and discuss in detail within the scope of this article. Two major items have been selected for discussion.

(Continued on page 750)

Cost of Producing Crude Petroleum

By Albert V. Smyrk, C.P.A.

Introduction

The production of crude petroleum is a relatively new industry compared with the mining of other natural resources classified under the major industrial group, viz., "Mining and Quarrying". Yet despite its belated entrance, it has become foremost in importance in the industrial development of this country and the world. It is now the second largest industry in the United States.

Much has been publicized in connection with the effects of inflation on operating and replacement costs in every industry, but in the production of petroleum, inflation was not wholly responsible for increased costs, the chief contributing factor being the cost of finding new reserves when the possibilities of petroleum occurrences have narrowed down to areas more difficult to prospect and explore and where the drill must go much deeper than heretofore.

The major problem of the producer today is to offset depletion of existing reserves by (1) new discoveries, (2) secondary recovery methods applied to existing reserves, and (3) marine exploration. This problem was generated by the great demand for oil during the war and the ever increasing demand in the years that followed in the process of catching up with the demand for durable goods, steel, farm machinery, automobiles, etc.

Albert V. Smyrk, C.P.A., was elected to membership in the Society in 1944, and is chairman of its Committee on Petroleum Industry Accounting. He is chief accountant of the Dominguez Oil Fields Company, and formerly served on the staffs of several prominent firms of certified public accountants. He is also an active member of the American Petroleum Institute and other societies.

The feverish hunt for oil in this country and South America during the decade 1930-1940 culminated in the discovery of oil reserves that have since not been duplicated. A possible exception to this is the discovery of oil reserves off the shores of Texas and Louisiana in the Gulf of Mexico; the extent of such discovery is as yet unknown.

Most of the oil produced in the Western Hemisphere at present is derived from reserves discovered during that decade, 1930-1940, and it is believed that they will continue to produce for years and years to come, but the hunt for new reserves must still go on. At present huge sums of money are being spent in search of oil in Paraguay, Alaska, Canada, Southern Mexico, Philippines, the United States and in the Gulf of Mexico, not to mention American capital invested in Iran, Iraq, and other parts of the world.

Studies on the cost of finding, developing and producing crude petroleum are now available at the Government Printing Office, if desired. The purpose of this article is to sketch in lay language some of the important present day operations involved in the exploration and production of petroleum as a background for consideration of the accounting involved.

The Petroleum Industry is divided into four main branches, viz., Production, Refining, Transportation, and Marketing. This article treats exclusively with production.

Let us first examine the nature of petroleum and its characteristics:

Nature of Petroleum

The word "petroleum" comes from the Greek—Petra, meaning rock, and oleum, meaning oil. Therefore, its literal meaning is rock oil, so named because centuries ago it was found in seepages around rock formation. In ancient times, the perpetual fires at the Pagan shrines are believed to have been

seepages of petroleum ignited on the surface. Hence, the first oil wells were seepage springs. Not until centuries later did it become known that oil could be obtained in quantities from the earth by drilling.

The four chief characteristics of a petroleum reservoir are (1) it must be porous, (2) it must be permeable, (3) it must be formed so that it will trap oil and gas underground, and (4) once the oil is removed from the reservoir it cannot be replaced. The first two, porosity and permeability, are the properties of an oil reservoir which permit it to store fluid and to flow it to the well opening by either natural gas or water pressure or by injection of water or gas under pressure. Oil itself, possesses no inherent energy by which it can be produced from a reservoir. The term "trap" means that the oil sand must be overlaid by a layer or rock, called the cap rock, which is not permeable to fluid, and underlaid by a similar impervious material or water. The fourth characteristic is that of a wasting asset.

Petroleum is crude oil before it is refined and may be brown, greenish, yellow, deep black or even whitish in color. It may be light in weight and feeling, or it may be heavy sticky asphaltic substance. The classification of the various types of petroleum into three groups, namely. Paraffine Base, Asphalt Base, and Mixed Bases, describe generally the nature of each.

Gasoline, kerosene, gas oils, fuel oils and a great number of by-products are obtained by refining the crude oil.

Methods of Finding Oil

The geology and technique of finding oil fills many textbooks. The vast reservoirs of new oil that were discovered in the 1930-1940 decade can be credited to the development of deep drilling and the employment of specialists in geology and geophysics. However, it is recognized that some of the major oil fields such as the East Texas field were discovered without geology or geophysics.

The modern search for oil on land or offshore comprises several distinct steps.

1. Mapping out an area for exploration
2. Scientific survey of the area
3. Executing a lease
4. Drilling of test holes
5. Drilling of a well

For land surveys and offshore operations the procedure is similar except that on land aerial photographs and surface indications are studied for possible oil structures beneath, whereas for marine exploration, the presence of oil on the shore line and the assumption that it extends into the open water is a safe theory to follow up as was done off the shores of Louisiana and Texas resulting in the more recent discovery of huge reserves in the Gulf of Mexico, known as the Continental shelf.

The Continental Shelf

The continental shelf is defined arbitrarily as the portion of our coasts running seaward to a depth of 100 fathoms (600 feet) and it is believed to be the source of a new supply of oil of great magnitude. The question as to who shall control drilling for this oil—the states on which the waters border, or the Federal Government—is still a matter to be decided by the courts. A depth of 100 fathoms is not reached in some places in the Gulf for a distance of 100 miles seaward.

Some geologists say that this is our greatest potential source of petroleum. Many producing wells are now operating in the Gulf of Mexico off the coasts of Texas and Louisiana in water ranging up to 50 feet in depth. The results of geophysical exploration of these waters indicate good prospects and that the oil deposits duplicate in type and character those found on the adjacent coast line.*

To a limited degree, marine drilling has been practiced in California for a number of years, being confined to

* Oil & Gas Journal, September 30, 1948.

wells drilled from piers extending a short distance into the Pacific Ocean, or by directional drilling on land near the shore line.

In offshore drilling the principal item of equipment is the drilling platform. This is a man-made island resting on piles. The piles are made of steel which are sunk into the bed of the Gulf and rising high enough above the high water mark to be above the crest of the swells that follow a severe storm, thus preserving the derrick, tanks and equipment installed on the platform from being washed into the sea. The cost of erecting such a platform runs into hundreds of thousands of dollars, exclusive of the well and all the water craft required to complete the equipment. In one instance, the cost of the platform alone was $1,200,000.

From these platforms they are now producing oil in the Gulf of Mexico at distances ranging up to 27 miles seaward, some wells being able to produce as much as 2,000 barrels daily, but the operators are confronted with two primary obstacles, (1) the question of an allowable rate of production under present conservation laws that will make offshore drilling economically possible, and (2) the best method of handling the produced oil—storing, measuring, testing and getting it to shore.[1]

Methods of Extraction

The discovery well is only the beginning of operations. The field has to be developed thereafter. Volumes have been written on the methods of extraction. Oil itself, possesses no inherent energy by which it can be produced from a reservoir. It will produce because of the presence of gas or water pressure in the underground formation. If gas or water pressure is not present, or if pressure drops, the petroleum must be lifted either by gas lift or pumping.

Primary method of extraction is the term applied to the procedures outlined above, which when associated with good engineering practice will recover about 25% of the oil in place for reservoirs with natural gas drive and roughly 50% for those having water as a propelling force.

This does not mean that the wells are no longer capable of producing when primary methods fail. In many instances again as much oil has been recovered by secondary recovery methods.

Secondary recovery operations are all practices other than primary methods, and include injection into the reservoir of gas, water, or air under pressure in order to supply artificial energy for the recovery of additional oil in place.

The importance of secondary recovery has already been demonstrated in the Bradford Field of Pennsylvania where primary production amounted to about 250,000,000 barrels. An additional 220,000,000 barrels has been recovered by water flooding and it is estimated another 100,000,000 barrels is still to be recovered from that field.[2] Every field is not adaptable to secondary recovery methods. Volumes have been written on this subject which is in its infancy.

Before dismissing the subject of extraction, it may be well to mention that drilling requirements are provided in every oil and gas lease whereby the lessee is obligated to drill periodically a sufficient number of wells consistent with good engineering practice.

Good engineering practice implies such matters as well completion, well spacing, rate of production, and in fact everything related to production methods, types of pumps and method of pumping, perforating pipe, separation of oil and gas, etc.

The objectives of drilling may be found in "Fundamentals of the Petroleum Industry", by Dorsey Hager as follows:

[1] Oil & Gas Journal, September 30, 1948, Page 67.

[2] Senate Committee Hearings, Independent Petroleum Companies, 1946, p. 333. U. S. Government Printing Office.

1. To bring in the well under control.
2. To drill a hole of size sufficient to obtain and to maintain a good production of oil or gas.
3. To exclude water from the oil or the gas sands.
4. To exclude caving shales and quicksands.
5. To shut off dry sands that might absorb the oil gas.
6. To Complete the test in as short time as possible.
7. To complete the hole at a minimum cost.

Production in Relation to Other Branches of the Industry

As previously stated, the Petroleum Industry has four main branches namely, Production, Refining, Transportation and Marketing. Some companies are engaged in all four branches, some are engaged in more than one branch, while others are engaged in only one branch.

In an analysis of thirty major oil companies made by Joseph E. Pogue and Frederick G. Coqueron of the Chase National Bank of New York, they show that as of December 31, 1947, the net investment by those companies in the various branches of the petroleum industry was as follows:

	Percent
Production	48.2
Transportation	12.9
Refining	21.5
Marketing	15.3
Other	2.1

Accounting for Oil Producers

Accounting terminology used in the production of petroleum together with definitions and descriptions of charges and credits that enter into each may be found in any one of several books listed in the Bibliography of Accounting for the Oil Industry published in the October, 1948, issue of this magazine.

"Practical Accounting for Oil Producers" by Robert M. Pitcher is a good reference book because it reproduces all of the ruled special forms and books used by producers in addition to a comprehensive description of the subject matter.

An outline of representative costs of finding, developing and producing crude petroleum with explanatory remarks is presented below:

An Outline of Representative Costs of Finding, Developing, and Producing Crude Petroleum

A. Finding or exploration expenditures:

1. Geologic, leasing, and scouting costs
2. Lease rentals
3. Taxes on unoperated acreage
4. Test well contributions
5. Dry hole costs resulting when drilling to a lower formation
6. Subsurface geological test well expenses
7. Surrendered leases

Exploration expenditures that result in the acquisition of leases may be capitalized as a part of the cost of the lease or all exploration expenditures may be expensed.

B. Lease acquisition costs:

1. Purchase considerations
2. Commissions and expenses of brokers
3. Quitclaim deeds
4. Ratifications
5. Options to explore in connection with acreage selection
6. Delinquent taxes paid for land owner that are not recoverable through deductions from royalties or otherwise
7. Amounts paid in defense of title to leases

The above items are ordinarily capitalized and maintained by lease as unoperated acreage until such time as the first well is completed as a commercial producer. Total capitalized cost for the producing lease is then transferred to an operated acreage account. Un-

operated acreage costs may be charged to expense if a lease is surrendered or the total acquisition cost for each lease may be amortized or depleted during the life of the lease.

C. Operated acreage:

Acquisition lease costs (included in "B") for acreage on which commercial production of oil or gas has been obtained are reclassified as operated acreage. The extraction or removal of oil and/or gas from operated acreage results in a decrease in the productive value of such properties. Therefore, in order to allocate the acquisition costs of operated acreages over the periods of production, it is necessary to charge as a direct cost of producing oil an appropriate portion of the cost. These charges to current operations are termed depletion provisions.

Depletion provisions may be computed by dividing the acquisition costs by the net recoverable reserve to determine a unit rate. The unit rate is then applied to the amount of production in an accounting period to compute depletion costs.

D. Costs for fee lands, leases, and easements:

1. Purchase price
2. Agent commissions
3. Legal fees
4. Survey fees
5. Purchase options
6. Sewer and paving assessments
7. Other expenditures constituting betterments of a permanent nature, for example, grading, filling, and draining fee lands

Fee lands, leases and easements may be acquired for well roads, pipe line rights of way, camp sites, district headquarters, riparian rights, and other similar uses. Acquisition costs of fee lands are not allocated of the costs of current operations. Acquisition costs of leases and easements are amortized during the useful lives of such rights. This is done by dividing the acquisition cost by the maximum useful life to compute the portion of cost applicable to the operations in each accounting period.

E. Development costs:

1. Costs applicable to drilling wells:

a. Intangible drilling costs:
   1. Rig rental
   2. Tool rental
      (a) Fishing tools
      (b) Coring equipment
   3. Rig supplies
   4. Drilling labor
   5. Transportation of drilling rig
   6. Mud and water pits
   7. Fuel and power
   8. Water
      (a) Purchased
      (b) Costs of drilling and equipping water wells
      (c) Supplied by field service system
   9. Direct supervision of tool pusher and engineers
   10. Mud and mud treating
   11. Temporary well roads, bridges, and canals
   12. Costs of preparing location
   13. District overhead
   14. Cement and cementing service
   15. Well logging
   16. Shooting and acidizing

Intangible costs include all expenditures that cannot be recovered or would result in little or no salvage value if the well results in a dry hole or at the time of abandonment of a producer. If the drilling well is completed as a producer, intangible drilling costs may be capitalized and allocated by the unit of production method to the cost of oil or gas produced during the productive life of the well, or all intangible drilling costs may be charges to expense currently.

b. Tangible drilling costs:
   1. Well casing and tubing
   2. Liner
   3. Packer
   4. Christmas tree
   5. Pumps

Tangible drilling costs include costs of materials and equipment that have a salvage value when removed from the well. If a drilling well is completed as a dry hole, tangible equipment may be credited from the drilling job at condition value. Condition value is based on the physical condition of the salvaged materials and the value of the material at the time it was charged to the job. The difference between the value charged to the job and the value credited would remain as an intangible charge. The total intangible costs for the dry hole would be charged to expense.

If a drilling well is completed as a producer, expenditures for tangible drilling costs are capitalized and allocated as a cost of production in the same manner as are the intangible drilling costs.

2. Costs of lease equipment:

a. Tangible lease costs:
   1. Flow lines
   2. Heaters
   3. Separators
   4. Oil treaters
   5. Storage tanks
   6. Chemical injectors
   7. Etc.

b. Intangible lease costs:
   1. Labor
   2. Transportation
   3. Fuel
   4. Consumable materials
   5. Other materials and supplies having little or no salvage value

Lease equipment costs are capitalized and may be allocated to the cost of oil or gas produced on the unit-of-production basis as described in the discussion of drilling costs. Operating expenses of lease and well equipment are direct production expenses.

c. Costs of field service system applicable to more than one lease:
   1. Oil treating system
   2. Electric light and power system
   3. Fuel gas system
   4. Gas compressor and pressure maintenance system
   5. Salt water disposal system
   6. Gas gathering system
   7. Gas lift system
   8. Oil gathering system

Field service systems, as the name implies, provide service necessary for operations and/or service required by state regulatory bodies. For example, fuel gas may be returned to a lease for heaters or treaters which would be necessary to produce oil for pipe line specifications. A compressor and repressuring plant may be installed in order to secure a greater production allowable from the state regulatory body although the lease could produce if the gas were flared.

The acquisition costs of field service units are capitalized and allocated to current operating costs by depreciation. All field service units in a producing field, district, or Company-wide may be grouped for depreciation purposes. Depreciation may be computed on a straight line basis, unit-of-production basis, or a modified straight line basis based on production as well as time. Many interesting accounting problems are encountered in the allocation of service unit expense, which is an indirect expense, to the cost of producing oil. This might be based on service-rendered basis, on a per-well basis, or by some other arbitrary method of distribution.

F. Costs of producing oil:

1. Operating costs:

a. Direct:
   1. Operating labor expenses
   2. Transportation
   3. Fuel and power
   4. Replacements and repairs
   5. Road expense
   6. Treating oil expenses
   7. Depreciation and depletion expenses

8. Production taxes
9. Ad valorem taxes

b. Indirect:
   1. District and division overhead
   2. Service system expenses
   3. Finding costs includes, dry holes, surrendered leases, leasing and scouting, exploration expenditures, etc.

2. General and administrative expenses:
   a. Salaries of administrative offices
   b. Salaries of employees in administrative offices
   c. Professional fees and expenses
   d. Administrative office expense
   e. Contributions and donations
   f. General taxes

All general and administrative expenses would be distributed as indirect expenses when determining the cost per barrel of oil.

3. Selling expenses (if applicable)

The Unit of Production method mentioned above is more fully explained, as follows:

Unit of Production Method

In those years of flush production when the "rule of capture" governed the volume of oil production, drilling and development expenses were in most cases charged to operations in the year incurred because the revenue derived from an incoming gusher would recoup the cost almost over night and subsequently furnish enough capital to drill another well and a big profit to boot. That may be termed the bonanza era. However, with the advent of conservation, whether voluntary or involuntary by state legislation, many producers switched over to the method of capitalizing intangible development costs as part of the leasehold cost. The systematic, orderly withdrawal of oil from a reservoir, lengthened the "payout" time on a new well also added to the financial burden of such well. This operating technique called for a systematic method of amortizing the development cost over the increased "payout" time on some equitable basis, so the "Unit of Production" method was conceived and it is in use by many of the major oil companies. It is similar to that used by other industries engaged in mining of natural resources. Using as a numerator the capitalized cost of drilling and development and other leasehold costs, and as a denominator an engineer's estimate of the recoverable oil in the reserve, a rate per barrel is established for the accounting period. This rate times the number of barrels produced is the charge to operations for "depletion". The same procedure may be applied for depreciation of plant and equipment in lieu of the straight-line and other methods.

The system has its drawbacks, especially during times of inflation when high replacement costs are not reflected in the rate per barrel of production representing depletion. The method of charging to operations all expenses in the year incurred is favored by many.

The controversy over "historic cost" and "replacement cost" is involved in the discussion of these two methods. In the long run, however, either method may be used so long as the amount capitalized is written off to income equitably over the productive life of the property. The productive life of a property can only be estimated, and there are so many factors that can change the estimate that it is safer and more conservative to charge the intangible portion directly to income in some cases.

Cost of Production

The elements which enter into the cost of production may be illustrated as follows:

Depletion or Charges in lieu thereof + Operating Costs + Finding Costs	Crude Petroleum Costs + Administration Expense	Cost to Produce

A glance at the above discloses certain peculiarities in petroleum costs which are not found in other industries, for instance an option on capital expenditures, the term "Intangible Development Expenses", and "Finding Costs." Raw material cost, which is a basic element of cost in other industries, is not represented as such because the crude petroleum in the ground is the raw material and its cost is represented by the depletion or charges in lieu thereof, as shown above.

The proceeds from production, after deducting royalties paid to landowners and other interests, must be sufficient to recover all the costs of Finding, Developing and Producing Crude Petroleum. It is the distribution of these costs equitably over the life of the property that makes the optional treatment of Intangible Costs desirable when it is considered that an oil reserve is a wasting asset and the productive life a matter of conjecture. Furthermore, the hazardous nature of the oil producing industry is the basic reason for privilege of writing off to expense the major portion of the cost of drilling and development.

The method of accounting for Finding and Drilling and Development Costs will produce different results when determining costs per barrel of production, as illustrated in the following example:

Assume: Company production during year of 1,000,000 barrels from wells completed some years ago with correct historic development cost of 30 cents per barrel. During the year the company spent $1,000,000 for new productive wells with estimated reserves of 1,000,000 barrels. With all other pertinent factors assumed to be the same, the effect of the difference in principle between the two procedures would be as shown below:

	Historic Cost Basis for Productive Wells		Replacement Cost Basis for Productive Wells	
	Total	Per bbl.	Total	Per bbl.
Gross income	$2,500,000	$2.50	$2,500,000	$2.50
DEDUCT:				
Operating cost	$ 500,000	$ .50	$ 500,000	$ .50
Development cost				
Historic	300,000	.30	—	—
Replacement	—	—	1,000,000	1.00
Finding cost........	700,000	.70	700,000	.70
	$1,500,000	$1.50	$2,200,000	$2.20
Profit margin	$1,000,000	$1.00	$ 300,000	$ .30

The replacement cost basis is predicated on the theory that replacement is the principal crude oil operation because the crude oil industry spends about half of its gross income in the search for, and development of, new reserves to replace oil consumed.

Specific Problems in Accounting for Oil Producers

The following are examples of some of the special problems peculiar to oil production accounting.

(1) Matching of production costs and revenues

(2) Cost of gas produced incidentally with the production of crude oil

(3) Pricing of transfers of lease and well equipment from one location to another, retirements, and valuation of oil wells that are converted for use as injection wells for gas or salt water.

(4) Problems of oil producers in accounting to royalty owners and other parties that have title to a portion of the oil produced

(5) Problems in accounting for offshore drilling and development.

Matching of Production Costs and Revenues

Most of the discussion on the subject of matching costs rotates around the Depletion account. In other words —What is the cost of the raw material in the ground?

Before it is produced, the cost of the oil in the ground may be represented in one or both of the following accounts, depending upon whether the operator capitalizes Intangible Development Costs or charges them direct to operations in the year in which incurred.

(a) Operated acreage, at cost. (Item C of outline)

(b) Intangible Drilling and Development Costs (Item E-I-a of outline)

As to item (b) a good percentage of the oil producers capitalize if the well is completed as a producer, allocating such cost by the Unit of Production method during the productive life of the well. Others charge these costs direct to operations in the year in which incurred. The Unit of Production method is described in the outline, item C and E-1-a and in a preceding paragraph.

In addition, there is another method for computing the unit to be used for cost depletion, the so-called "California System" which brings into the computation another factor. When Intangible Development Costs are capitalized an estimate is made of the intangible cost of developing the whole field. This estimated cost is divided by the estimated ultimate recovery for the entire field and the unit thus obtained. When this system is used, a separate computation is necessary for income tax purposes based upon actual cost.

Either method is appropriate under accepted accounting principles, provided the capitalized sum is allocated to income equitably over the productive life of the property. However, the productive life of a property is the subject of a good deal of conjecture, as there are so many factors that can alter the estimate. Consequently, it may be considered more conservative to charge the intangible development costs direct to expense in the year incurred in some cases.

This optional treatment of the largest expense of an oil operator has generated a problem in recent years causing many large producers who capitalize such costs to explain in their stockholders' annual reports that profits were overstated. The reason given was that crude oil shipments were made from reserves discovered years ago at relatively low cost while the cost of replacing the reserves during a period of rising prices and when it was more difficult to find oil was not reflected in the accounting figures. In other words, the unit rate used for depletion was inadequate to retain amounts sufficient for replacement purposes.

Now that we have passed through a few years of inflated prices, costly drilling, and exploration, the unit rate should increase each year and in the long run cost will be absorbed in operations. There are still those that believe a more accurate method of reflecting economic fluctuations should be acceptable to industry and particularly the Treasury Department.

Cost of Gas Produced Incidental with the Production of Oil

Where does the cost of crude end and where does the cost of gas begin when both come out of the same well? A practical aspect of this question is to disregard the cost of the gas entirely and allocate the entire cost of production to crude oil. The revenue derived from the sale of gas and casinghead gasoline is then added to the revenue from the crude oil and both considered as being derived from the primary objective, production of crude oil.

Unlike oil, gas has no posted price. Retail prices are subject to control of State public utility regulatory bodies and the gas companies have to purchase at a price that will yield a profit. The gas company sometimes pegs the price that it will pay for all gas purchased in a locality, but more often prices will differ materially in some localities, each purchase contract being a private transaction.

Among those problems that will come up when the Senate and the House reconvene in 1950 will be one in connection with natural gas. The House in 1949 passed a bill to exempt producers from regulation by the Federal Power Commission when they sell gas at armslength to interstate pipe line companies. The bill is pending in the Senate, where several attempts to take it from the Senate Rules Committee failed in the closing days of the last session, and a hard fight is ahead for the measure.*

Since most oil companies are primarily engaged in the production of oil it may reasonably be held that revenue derived from the sale of gas is just so much more revenue from the sale of oil, and this is generally accepted because it is simple and practical. Any segregation of the cost of production to gas would have to be arbitrary and would offer no solution if one is desired. Prorating the cost of production on the basis of realization is not generally practiced by operators engaged primarily in production of oil.

The natural gas as it comes out of the oil well is called wet gas and contains gasoline in vapor form, and in that state has no commercial value. After processing wet gas, the casinghead gasoline is obtained and the resultant gas is called dry gas, which then has a commercial value and is purchased by the gas companies.

The cost of processing the wet gas is deducted from the revenue derived from the sale of gasoline, so that the revenue from dry gas and gasoline represent the amount realized at the well head.

Transfers of Lease and Well Equipment

Thousands of transfers of new and used equipment take place during a year in a large oil company. Materials are removed from one lease to another, from one district to another, from one well to another, or from a lease or district to an outside purchaser.

Owing to the regular occurrence of this practice throughout the industry, a consistency in the matter of pricing has developed, especially when the equipment is jointly owned by operator and non-operator in a joint project. The basis is not on cost, but on the current new price, and the valuation is 100% for new, 75% for used, 50% for used needing repair, 25% for useless but appropriate for a different purpose and junk value for junk.

As a consequence, the values are different from the residual values on the books, and the question how to adjust the fixed asset accounts and their related reserves for depreciation becomes troublesome, especially when there is no intention of making a profit or loss on the transfer.

On jointly owned equipment the price is prorated between the operator and non-operator in proportion to their respective working interests.

It is immaterial what method is used to record these transfers so long as there was no profit motive, for the practical reason that you cannot spend

* *Daily Oil News*, November 9, 1949.

a paper profit, nor can you suffer a paper loss.

A similar problem arises when a non-productive well is converted into an injection well for storing unsold gas, for pressure maintenance or for secondary recovery operations (water injection, etc.). If the well has produced oil in the past, its cost will have been recovered through depreciation charges on the Unit of Production method of depreciation and depletion, leaving no residual value on the books, except possibly salvage value.

There is no standard practice for valuing such a well after conversion, but it would appear that it should be taken out of the well investment account and the Reserve for Depreciation account and new accounts opened with different titles. The alternative would be to leave it in the well investment account until finally abandoned as useless for any purpose.

As secondary recovery gains momentum there will be more of these situations and when that stage is reached some practical minded individual will offer a solution.

Accounting to Royalty Holders

An oil royalty is an "Economic Interest" and is subject to depletion from an income tax standpoint. These and other characteristics make it somewhat different from a fixed royalty paid to the owner of a copyright for books published and sold or to the owner of a patent for articles manufactured and disposed thereunder.

It is an "economic interest" because the owner of the land has reserved for himself a share of the product or the proceeds realized therefrom when permitting another to use the property. It is compensation for the privilege of drilling and producing oil and consists of a share in the product.

Although a royalty originates with the land owner who leases the property for development, he may split up his interest among several investors who seek to purchase a fractional part. The lessee may in turn sublease the property to another and retain for himself an additional part of the production and this is known as an overriding royalty. The holder of an overriding royalty may also split up his interest into several smaller segments by assignment to others. Consequently there may be many interested parties in the production of the oil.

The reason for this is that the value of a royalty in some instances is considered to be equal to all the rest of the interest subject to development, drilling and operating costs (G.C.M. 22,730). That portion of the oil which is retained by the royalty holders is free of the burdens of development and operating costs and has a value sometimes equivalent to the entire interest subject to such burdens.*

The market value of the crude oil at the time of production is generally the basis for settlement and only in some isolated instances will the oil lease call for royalties based upon a fixed amount per unit of production.

In some oil properties there are so many individuals owning small fractional interests that the operator designates a trust company to distribute the payments to the royalty holders.

The "Pipe Line Run Ticket" is the basis for all oil settlements. On this form is recorded the number of barrels of crude oil that is taken from the tanks into the pipelines. In addition, the gravity of the oil is entered, percentage of water and basic sediment, also temperature of the oil. Most oil settlements are made on the basis of 60° temperature. After adjusting the quantity for temperature, water and basic sediment, the resultant number of barrels constitutes the basis for settlement at the market price or posted price.

Since the operator usually purchases the oil from all of the royalty holders, the cost of drilling, development and operating the wells is allocated to his share of the oil in place. As an illustra-

* See, in this connection page 115, "Oil and Gas Federal Income Taxation," by Kenneth G. Miller, Commerce Clearing House (1948).

tion, if a producing property has a one-eighth royalty interest held by some one other than the producer, it is considered that the producer's cost of the lease and of development, etc., is applicable to seven-eighths of the oil in place, so that technically one-eighth of the oil in place or produced actually belongs to the holder of the royalty right.

Joint Ownership

Every major oil company engaged in producing and refining of oil enters into agreements with others to operate their fields, acquiring an interest in the oil in place, and agreeing to purchase from the non-operators their share of the oil at the posted price in the vicinity of the oil field. These agreements are usually referred to as operating agreements and contain sections devoted to accounting procedure covering the method of charging the non-operating partner with his share of the development and operating charges, the basis of charges to joint account, disposal of lease equipment and materials, basis of pricing materials transferred from joint lease, agreement to purchase the oil at the posted price in each locality as well as purchase of gas and casinghead gasoline.

To the operator, this relationship is called an "outside interest" and a special employee called the "outside interest man" is placed in charge to supervise the contractual relationship.

There are many different types of operating agreements, the majority being on a 50-50 basis, meaning that all the oil field equipment is jointly owned with the exception of a few larger units such as gasoline absorption plants, compressor plants and pipe lines running through the field. These are usually the property of the operator. The development and operating charges are divided equally and, in addition there is a surcharge for the supervision and management by the operator.

The non-operator follows in a general way the accounting methods of the operator. This does not mean, however, that they should agree on method of charging the accounts on the books, or policy of capitalizing intangible drilling and development expenses, depreciation and depletion, etc. As a matter of fact, the small independent producer does not require an elaborate system of accounting in as much as he is not engaged in refining and marketing operations as would be the case with the large integrated company whom he has elected as the operator of the field.

Operating agreements generally give to the non-operator the right to examine the books of the operator.

Offshore Drilling and Development

Drilling and producing operations on the continental shelf have been accompanied with problems heretofore unknown to the oil operator. There is the wind, waves, hurricanes, construction of steel platforms in the open waters, purchase of water craft for hauling drilling equipment out to sea, drilling of several wells from one platform by directional drilling methods, permits that must be obtained from the State on whose shore the drilling is done, regulations of the United States Coast Guard governing the building, operation, and manning of vessels used in waters controlled by the United States, Federal Communications Commission rules and regulations covering the use of radio communication between shore and boats and wells at sea, etc.

Obviously, the cost of production in offshore operations is much greater than land operations. Drilling a well offshore costs three to five times the cost of a well on land, and the cost of all the other necessary equipment results in a huge investment to be amortized and depreciated over the life of the wells. The occurrence of hurricanes in the months of July, August and September makes it necessary to shut down operations during a portion of this period, with the result that another

unique accounting problem presents itself, that of "idle time expense". On land operations the only time wells are shut down is for repairs or when they become unprofitable.

Conclusion

In this brief elaboration on the subject of costs, some operating procedures have been touched upon as a background for the accounting involved.

By a series of continuous progressive changes, a complex accounting technique has developed from a simple beginning. Nevertheless, some accounting methods instituted over 30 years ago are still in use. In addition, new accounting problems have sprung up within the last year in connection with offshore exploration and development, and certain weaknesses have developed in time-honored methods of computing depletion and depreciation by the unit of production method. A discussion of the development of synthetic liquid fuels from coal and the mining of vast oil-shale deposits will be more timely in the future than at the present.

So the industry, as it constantly faces changes in operating techniques, may find it necessary to overhaul its accounting policies from time to time. We cannot escape the fact that very little has been published on petroleum accounting. Accountants await with interest any additions to accounting literature pertaining to this important industry.

Independent Audits of New York State Villages

(Continued from page 737)

These types have been selected primarily because they represent the most significant amounts from the standpoint of dollar value in village fiscal affairs. They are (1) expenditures from bond proceeds and (2) repayment of short-term borrowings made within the budget year.

The law (See McKinney's Consolidated Laws of New York, Annotated, Book 33, Local Finance—paragraph 165.00) provides that bond proceeds shall be expended only for purposes authorized by the resolution for issuance of the bonds, and that any unexpended balance of the proceeds shall be applied to the payment of principal and/or interest on the bonds.

Audit steps should determine that expenditures made from bond proceeds are in accordance with provisions of bond resolution. Such verification can be effected by relating the authorization for the bond issue to the vouchers supporting charges to the project or projects on which the money has been expended.

The audit should result in clear and unmistakable segregation of unexpended balances of bond proceeds so as to assure that they will be used only for bond retirements or payment of interest. It is recommended that such amounts be deposited in a separate cash account to prevent commingling with current cash balances.

Repayment of short-term borrowing within the current budget year may arise as the result of borrowings in anticipation of tax collections or of bond issues. This type of borrowing is normally evidenced by resolution of Village board and cancelled notes on hand. Verification is relatively simple and involves agreement of, amount repaid as reflected by original authorization, the cancelled note, voucher supporting expenditure and recorded disbursement in the cash book.

Conclusion

The preceding pages have summarized the need for audit services in New York State Villages, as well as the major audit problems and suggested steps for their solution. It is hoped that the reader of this article will have gained a concept of the audit work demanded by a Village examination and the services that the independent public accountant may render to Village officials and taxpayers.

The Work of the Committee on Professional Conduct (1948-49)

By J. P. Friedman, C.P.A.

Probably every member of The New York State Society of Certified Public Accountants knows that the Society has a Committee on Professional Conduct, but relatively few of the members are familiar with its work. It is charged with the task of expounding proper professional conduct under the Society's "Rules of Professional Conduct," and of inducing compliance with these rules. There can be no doubt, of course, as to the wisdom and desirability of maintaining the highest standards among our members. However, since not every certified public accountant is a member of the Society, this raises the very important problem of how to maintain proper standards of professional conduct uniformly among *all* certified public accountants. As will be seen from what follows, this is a matter requiring our careful consideration.

I shall proceed to outline the more important matters that came before the Committee during the past year, omitting the very large number of relatively simple matters relating to the interpretation of the Rules of Professional Conduct, that were disposed of by telephone conversations. The majority of the cases, as in the past, dealt with advertising and solicitation. Of the many types, the most flagrant was the advertising soliciting clients, that appeared in a leading newspaper. There was also a continuation of advertising in telephone directories. In addition, there were cases of direct solicitation by letter and indirect solicitation by mailing what purported to be technical articles.

J. P. Friedman, C.P.A., has been a member of our Society since 1919. He is also a member of the American Institute of Accountants and of the National Association of Cost Accountants.

Mr. Friedman is a member of our Committees on S. E. C. Accounting and on Retail Accounting, and of the Institute's Committee on Accounting Procedure. He was formerly a director of the Society and is the past chairman of the Committee on Professional Conduct.

He is a partner of Touche, Niven, Bailey & Smart, New York, N. Y.

Newspaper Advertising (Rule 9)

The newspaper advertising in question was noted by the Committee, and it was also reported by a number of the members. Letters from the Committee to the certified public accountants who advertised brought no replies and the individuals involved, not being members of the Society, were not subject to disciplinary action by it. Another course of action was adopted and the advertising was finally discontinued.

Advertising by Circular (Rule 9)

The situation as to outright advertising by circular leaves much to be desired. The Committee has written to many individuals advertising in this fashion and some have agreed to discontinue their advertising. In other instances no replies have been received and there is little the Society can do when the individual is not a member.

Telephone Directory Advertising (Rule 10)

Advertising in telephone directories still continues despite the strenuous efforts made for several years to have it discontinued. Letters were written to a

number of the advertisers and some of them promised to discontinue advertising. A great deal still remains to be done in this field.

Dissemination of Printed Articles (Rule 10)

It is the custom of many accountants to send reprints of technical articles to their clients and, of course, there is no objection to this practice. Several cases came before the Committee in which an accountant sent a technical article to the client of another accountant, contrary to the subdivision of Rule 10 dealing with the dissemination of printed articles and, also, in violation of Rule 9, which prohibits the solicitation of clients. In one such case, however, it was found that the accountant mailed such reprints to his own clients, only, but where the clients showed them to others and these others requested copies of the article, the request was complied with by the accountant. Obviously, this was not a violation.

Advertisement of Professional Attainments (Rule 10)

Another case came before the Committee in which a stock brokerage firm, in recommending a list of securities, stated that the resident partner and manager, who was a Certified Public Accountant, would be available for the discussion of any problems without charge. The member who submitted the matter thought that this was a violation of the rules against advertising, but it was found that the certified public accountant referred to was not practicing his profession, and that apparently the problems which he would discuss free of charge related to his new business—that of stockbroker—instead of to his work as an accountant.

Use of Accountant's Letterhead in Charitable Fund Drives (Rule 10)

One of the members of the Society wrote to the Committee taking exception to the use by accountants of their letterheads in writing letters of solicitation for charitable contributions — the letters which he submitted requested donations for well known charitable organizations. He stated as follows:

> "I do not want to be a diehard and, while perhaps there is nothing improper in the procedure, I do not believe it is the highest of ethics to circularize a wide public on firm letterheads. I realize the accounting profession should contribute to all worthy causes, yet I believe it would be much nicer and more ethical to use the stationery of the eleemosynary institution which is being helped. Some identifying designation could be made thereon such as 'Accountants Committee' or the Chairman of the Committee could use his personal (not business) letterhead. There are other alternatives such as using the 'Society's' or the 'Institute's' letterheads—any way but the present method."

The Committee discussed this matter and came to the conclusion that there can be no problem of solicitation involved so long as the letters go only to members of the profession, and this was apparently the situation in the instances complained of. The status might be totally different if an accountant were to use the firm letterhead to solicit contributions from clients of another accountant.

Announcement Cards (Rule 10)

A similar problem presents itself with regard to the announcement of the opening of a new office or the admission of a new partner. In one case the announcements were apparently sent broadcast, because in at least that instance an announcement reached a firm which employed another accountant and with whom there was no apparent previous personal contact. The Committee held that it is against the Rules of Professional Conduct to send announcements in this manner. The member who sent it tried to draw an analogy with the recognized propriety of inserting a similar announcement in the newspaper, but it was the opinion of the Committee that the two situations are not alike.

Announcement of the admission of

partners and the addition to the staff of key personnel gave rise to complaints. The Committee has held that there is no objection to the announcement listing the qualifications and former connections of an individual admitted into partnership but that it is not proper to do so in the case of key personnel. It should be stated, however, that the American Institute of Accountants is not equally clear as to its position with regard to key personnel and the entire subject is now under discussion.

Retention of Books and Tax Returns

Several cases came before the Committee concerning the refusal by an accountant to give up books of account and tax returns because his fee had not been paid. This is contrary to a statement adopted by the Board of Directors on June 21, 1945, which states as follows:

> The Committee on Professional Conduct has received inquiries from former clients of members as to whether they are entitled to receive from their former accountants, file copies of tax returns or other documents prepared for submission to federal, state and municipal taxing or regulatory authorities, if they have at no time received such copies from the accountant during the course of the engagement.
>
> It is the opinion of the Committee that the failure to provide copies of such returns is discreditable to the members concerned, embarrassing to business men and constitutes a violation of the final paragraph of the Rules of Professional Conduct as set forth in Article XVIII of the By-Laws.
>
> In case an accountant has supplied a client or former client with copies which have been lost or mislaid by such client, it is the opinion of the Committee, that the accountant, upon request of the client, should supply copies of the returns and may make a reasonable charge for the actual time required to prepare the copies.
>
> It is hoped that this general statement will make it unnecessary for the Committee to act on specific complaints.

In most cases the Committee was able, after pointing out these rules, to have copies of the tax returns furnished to the client. The position is similar with respect to books of account in the possession of the accountant, even though this statement does not specifically cover that subject.

Improper Inclusion of Name in Firm Name (Rule 3)

The Committee had a complaint to the effect that a certified public accountant permitted his name to be used in a firm name even though he had never been connected with the firm. This was held by the Committee to be in violation of Rule 3 and the accountant agreed to have the use of his name eliminated from the firm name.

Propriety of Inclusion of Name of Deceased Partner in Firm Name

Amongst the inquiries which came to the Committee was one from a Board of Accountancy in another country which inquired as to the propriety of the use in a firm name of the names of deceased partners. The American Institute of Accountants had considered this subject at a meeting held in October, 1943, and at that time had adopted a resolution as follows:

> WHEREAS, The American Institute of Accountants Committee on State Legislation has requested the Council of the Institute for an expression of opinion as to the Institute's policy toward legislative proposals which would prevent continuation of a firm name containing the names of former partners who have died or who have withdrawn from the partnership, and
>
> WHEREAS, said Council of The American Institute of Accountants believes it desirable that the policy of the Institute on this question be recorded;
>
> NOW THEREFORE BE IT RESOLVED, that in the opinion of the Council of The American Institute of Accountants neither the public interest nor the interest of the accounting profession as a whole would be served by legislation preventing the use by public accounting firms of firm names or titles which contain the names of partners who have died or withdrawn from the firm; and be it further
>
> RESOLVED, that the Committee on State Legislation be instructed to oppose legislative proposals of the type described in this resolution.

A copy of this resolution was furnished to the inquirer, as also representing the

Committee's views. It is contained on pages 114 and 115 of the excellent book by John L. Carey entitled, "Professional Ethics in Public Accounting."

Incompatible Occupations (Rule 14)

Another inquiry that was submitted to the Committee was whether a practicing certified public accountant may at the same time devote part of his time to insurance brokerage. The Committee held that there is nothing incompatible in an individual engaging in these two occupations.

Independence of Accountant (Rule 7)

An attorney wrote to the Committee stating that he represented a certified public accountant who was also an officer in a finance company which purchased negotiable instruments issued by some of his clients. He inquired whether in reporting upon statements for his clients whose negotiable instruments were purchased by the finance company, he must make a disclosure of his interest in the finance company. The Committee pointed out that the Securities and Exchange Commission had ruled that if an accountant has an investment (of significance to his own net worth) in a company which he audits, he ceases to be independent and that, accordingly, his statements will not be acceptable under the Securities Act. The theory is the same as that under which a judge disqualifies himself if he has any interest in the subject matter of legal proceedings coming before him officially. It was further explained that, in the instance cited, although there was no ownership of stock, yet there was ownership of negotiable instruments of the client. It was explained that it is the Committee's opinion that just as an auditor is not independent if he owns a client's capital stock, it follows that he would also not be independent if he owns a prior obligation, such as a negotiable instrument of the client. It was further explained to the attorney that there is no prohibition against a certified public accountant issuing a report under such circumstances so long as the report discloses his interest in the company; and that this is mandatory not only for annual reports but also for all interim reports. By having an interest in a factoring company which owns negotiable instruments of his client, he ceases to be independent but he notifies the reader of this fact so that the reader may be informed of a very material fact.

Conclusion

In conclusion, may I state that the Committee on Professional Conduct is always ready to assist all certified public accountants, whether members of the Society or not, in solving problems arising under the Rules of Professional Conduct.

The New York School of Accounts

By The Committee on History

Prior to the establishment of the School of Commerce, Accounts and Finance of New York University, which opened its doors on October 1, 1900, a much needed facility for the training of recruits for the rapidly growing profession of accountancy was the New York School of Accounts, an enterprise personally conducted by Theodore Koehler, a Certified Public Accountant who had an office in the St. James Building at Broadway and 26th Street, New York City. There had been an earlier school with the same name, which was chartered by the Regents in 1892, and financed and operated by the American Association of Public Accountants in 1893-94. This institution, however, was short-lived and was dormant at the time of the passage of the C.P.A. law in 1896. In *Accountants Directory* and *Who's Who,* 1925, page 540, Mr. Koehler's biographical sketch stated that he "organized and incorporated the New York School of Accounts immediately after enactment of the C.P.A. law, the first school in the United States devoted to the preparation of students for the C.P.A. degree." His booklet, *A New Departure,* 1909, described the school as, "Established, 1897. Incorporated, 1905."

This is the third of a series of articles on the History of Accountancy in the State of New York, prepared by the Society's Committee on History. The first two articles, published in the March and May, 1949, issues of *The New York Certified Public Accountant* dealt, respectively, with the early development of accountancy in New York State and the genesis of The New York State Society of Certified Public Accountants. The organization and early history of the School of Commerce, Accounts and Finance of New York University were discussed briefly in the first article.

Theodore Koehler was the holder of Certified Public Accountant Certificate No. 76, issued under the New York State law that became effective with the signature of Governor Levi P. Morton on April 17, 1896. He was a member of the State Senate when the C.P.A. bill was introduced and actively advocated its passage. He sensed the need for specialized training in preparation for the new certificate and shortly after the enactment of the law he started a school which offered instruction in bookkeeping, accounting theory and practice, auditing and commercial law, on a level high enough to meet the requirements of the new law (which was the first of its kind in the United States).

The school was housed in a room adjoining Mr. Koehler's office and was equipped with high bookkeepers' desks and other appropriate furnishings. Mr. Koehler planned and personally directed the course of study. He was assisted in teaching by his small office staff and by the student-teachers as they progressed in the course. The reading of treatises on accounting and auditing was encouraged. Lectures on commercial law and technical subjects were given by experienced public accountants. Sessions were held in the late afternoon and evening hours. There were no organized classes; instruction was individual and students were permitted to complete the course according to the time and skill which each could devote to it.

The enterprise was a success from the start. Besides Theodore Koehler, the instructors included former students, some of whom were:

Theodora Daub, a student in 1904.
Benedict F. Buhle, a student in 1903 or 1904.
Frederick Haberstroh, a student in 1904.

As lecturers were:

Frank Broaker
Joseph Hardcastle
Arthur W. Smith

Among the students enrolled were the following:

Diedrick P. Bierman	Charles C. Goldsborough
Herbert G. Collier	Harold Dudley Greeley
William D. Cranstoun	Frederick Haberstroh
Theodora Daub (Koehler)	Henry Abbott Horne
William Henry Dennis	Orrin R. Judd
James J. Driscoll	Samuel D. Leidesdorf
Edward J. Enthoven	Harriet B. Lowenstein (Goldstein)
A. S. Fedde	John H. May
John Fraser	Homer S. Pace
William Fraser	William Sheperdson
John Gordon	Alfred J. Stern
Ernest N. Wood	

"A New Departure", issued by the School in 1909, shows the following:

Officers: President	Theodore Koehler
Vice-President	Albert Bierck
Treasurer	Richard M. Chapman
Secretary	Duncan MacInnes

Trustees:

Henry R. M. Cook, CPA	Duncan MacInnes, CPA
Richard M. Chapman, CPA	W. F. Weiss, CPA
Albert B. Bierck, CPA	Theodore Koehler, CPA
Charles H. Stocking, CPA	Franklin Allen, CPA
William Raimond Baird, LLB	

Many of these names will be recognized as certified public accountants who in later years achieved distinction in public accounting and business.

A booklet, issued about 1910, listed 67 students of the School who had already passed the C.P.A. examination. Mr. Koehler was offered an opportunity to join the faculty of the New York University School of Commerce, Accounts and Finance, but preferred to continue his independent teaching.

Theodore Koehler had a colorful career. He was born in the duchy of Schleswig-Holstein, then a part of Denmark, on June 30, 1856, and was educated in the schools of that country. In 1876, as a young man of twenty, he came to the United States, landing in Philadelphia. He was disappointed in not finding the employment which he had reason to expect and undertook such work as he could find. This included representation of an English firm on an exploring expedition to South America and as an exhibitor at the New Orleans Cotton Exposition of 1884.

In 1885, be became head bookkeeper and auditor for the East River Gas Company at Long Island City, New York, a position which he held for about ten years. At about the same time he was employed by a number of business firms to adjust their accounts and later was engaged by the municipal authorities of Long Island City to make an examination of the books of the City Departments covering a period of years. Largely as a result of the reputation he

made in these assignments and his contact with local politics, he was nominated and elected in 1893 to represent the City on the Queens County Board of Supervisors and served with distinction for two terms. His name was particularly associated with measures for highway improvement and the construction of a tunnel under Newtown Creek. In 1896 he was elected to the State Senate, serving until 1898. He was a member of the Committees on Finance, Insurance, and Agriculture.

As already noted, one of his early students was Theodora Daub. Later she assisted him as an instructor in the School and also as a co-author of some of his books. Still later they were even more intimately associated when on June 24, 1920, she became Mrs. Theodore Koehler.

Mr. Koehler was a man of boundless energy, a forceful speaker and a prolific writer on accounting subjects. He published "The Accounting Mentor of Theory and Practice" in two volumes; "Manufacturing Accountants Manual" in three volumes; "Municipal Accountants Manual", and a series of thirteen volumes called "The Accounting Quiz Answerer." He died in his seventy-third year on March 27, 1929.

AN ADIRONDACK VIEW

ORION is with us again. When we do some pressing office work evenings, quit at eleven o'clock and put the car to bed in the garage, there is Orion standing cock-eyed in the eastern sky.

The same three stars are straight in line for his belt. No act of Congress, office decision, accounting research bulletin, union policy board action or article in Pravda has changed their size or their position. That's lucky—otherwise they would be around his neck by now!

And Orion is still there even though it is cloudy and you can't see him. Probably there are many other things that are facts even when you and I, and fact finders, and Mr. Stalin, and others we could name, can't see them.

But there is one thing we can all see, and that is that the time of the ancient winter festival and the modern Christmas is at hand. So may we all hope, for all the world and all its people, just a little more goodwill this year than last, more recognition of others' needs and rights, and less of grabbing and shoving to get things for ourselves—even in the subways!

LEONARD HOUGHTON, C.P.A.
of the Adirondack "Chapter"

New York State Tax Clinic

Conducted by Benjamin Harrow, C.P.A.

Tax Situs and Allocation

The National Tax Association recently held its annual conference in Boston. In 1947, the National Tax Association had appointed a committee to study the question of the situs of sales for purposes of franchise and income taxation, to continue the study of a uniform statute that the Association had been studying for a number of years, and to prepare a uniform sales situs act. In advance of the Boston conference the committee issued a preliminary report to members of the Natonal Tax Association. One of our members, Leo Mattersdorf, is a member of this special committee, and had been chairman of a previous committee on Allocation of Income. This committee, after years of work and study of this problem, reached certain conclusions and made certain recommendations.

The first recommendation was that the states should permit the use of separate accounting by any business that maintains an adequate accounting system, which will enable it to ascertain with reasonable accuracy the net income in each of the states in which the business operates. New York, of course, does not at the present time permit an allocation on the basis of separate accounting, and the courts have sustained the state where the taxpayer argued that his separate accounting more equitably reflected the income allocable to the state than the allocation formula provided in the law.

The National Tax Association has been interested in establishing a uniform system of allocation for all states. The committee therefore recommended that uniformity would be most readily obtained by the use of the factors of tangible property, payroll, and sales in an allocation formula. Fifteen states, including New York, now use this formula; five use a formula based on the factors of property, manufacturing costs, and sales; and seven use a formula based on the factors of property and sales.

A third recommendation was that the "Massachusetts formula" should be used in the case of taxpayers engaged primarily in manufacturing or mercantile activities; and further, that in determining the situs of sales, consideration should be given to the state of destination of merchandise sold and the state from which salesmen making the sales operate, each state being weighted at 50%. Such a treatment would, in our opinion, give proper consideration to the interstate activity of most businesses in our modern economy. If New York were to adopt this recommendation, the administration of the franchise tax law particularly, would be considerably simplified. It would do away with such fine distinctions as regular place of business versus permanent and continuous place of business. It would do away with the hairline differences in

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Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

the treatment of sales resulting from the place of acceptance of orders and the location of merchandise at the time of its appropriation to orders. When the new franchise tax law was enacted in 1944, the Commission did consider this recommendation, but hesitated to adopt it because it was of the opinion that too much revenue might be lost to the state if it did adopt it. The recommendation has so much to commend it that it would seem to be worth trying. Any loss in revenue could be made up through an increase in the tax rate.

The Committee recommends the use of a two factor formula, payroll and gross receipts, in the case of taxpayers primarily engaged in rendering personal services. Our New York law permits the use of two factors if the three factor formula is inequitable.

The Committee also recommends that Tax Commissions should have sufficient powers to employ an equitable apportionment procedure to prevent undue hardship. Specifically suggested are the use of additional or substitute factors or a reduction or increase in the weight given to the prescribed factors. The New York State Tax Commission under the present law has such powers.

In the case of loan companies, the Committee recommends the allocation of interest to the state in which the office is located from which the loan was made.

Other Comments from the Preliminary Report

The Committee made no recommendation at this time on the problem of uniformity of inclusion of property in the property factor, nor of valuation of property. It also does no more than state the problem of inclusion of rental property in this factor to prevent discrimination against taxpayers owning property. It should be noted that our Tax Commission is struggling with this latter problem at the present time.

The Committee also is considering the problem of how much weight should be given to the factors in the "Massachusetts formula" and the collateral problem of jurisdiction in the case of the destination factor of sales situs.

Some Principles and Factors Pertaining to the Income Tax

There has always been the problem of double taxation of income under the many state income tax laws. The preliminary report lays down as a general objective the principle that state income tax laws should tax only that segment of income of a business which reflects the economic activity of the tax entity within the state. The economic activities should be those which produce income. Included among such activities are the use of property; efforts of employees in selling, buying, manufacturing, research, operating, assembling, storing, and distributing; and efforts of management in the selling operations, the merchandise operations, and the training program. The real problem will be to provide a method of allocating these activities to the states in which such activities are carried on. The committee realizes that there can be no precise determination of the actual dollar amount of income that is derived from any one of the economic activities and, therefore, some practical approach to the allocation problem must be taken. If a taxpayer is carrying on activities within and without the state some allocation should be permitted.

It is suggested that where the activities in one state are entirely unrelated to the activities in another state the separate accounting method for allocating income should be permitted.

Gross Receipts Tax

In the September, 1949, issue of the New York State Tax Clinic (p. 582) we discussed the meaning of gross receipts, emphasizing the distinction that should be made between advances for clients and business expenses. In Report Bulletin #7 of the New York Tax Service, dated October 10, 1949, Prentice-Hall has an editorial comment on

this very point. Prentice-Hall agrees with our conclusion that reimbursable expenses in the nature of advances or loans are deductible. Among those reimbursable expenses, Prentice-Hall mentions service and filing fees, printing bills, court costs, bonding charges, investigators' fees and appraisers' fees. It is important that the professional man who is concerned with this type of expenditure should keep a permanent account of these charges in his books and records. If possible, bills to clients should disclose the disbursements.

Franchise Tax—New Rental Factor in Allocation Formula

The Tax Commission has now issued a new regulation (Art. 412.1), incorporating in the property factor of the allocation formula, property which a taxpayer does not own but for which he pays a rental. The value of real property rented to a taxpayer must be determined for inclusion in the property factor both with relation to property rented in New York (the numerator of the factor) and property rented outside of New York (part of the denominator of the factor).

The regulation provides that the value of rented real property is determined by multiplying the gross rents payable during the base period by 8. Gross rents include any amount payable for the use or possession of real property such as a percentage of sales, profits, or otherwise. It includes also "interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease * * *."

If any improvement to real property is made by a lessee, a proportionate part of the cost is included as rent. The improvement is charged off as rent over the unexpired term of the lease or over the life of the improvement if that is less than the unexpired term of the lease.

Where a building is erected on leased land, the value of the land is determined by multiplying the gross rent by 8. The value of the building is determined separately in the same manner as if the taxpayer owned the building.

If the lessor and lessee are taxed on a combined basis under Article 9A intercompany rents are eliminated. Charges for water and electric service are not included in gross rents. Neither are amounts payable for storage, unless a designated space is rented to a tenant for storage purposes and the space is under the control of the taxpayer.

The regulation recognizes the fact that the use of the general method for valuing rented real property may result in inaccurate valuations. In such cases any other method may be adopted either by the Tax Commission or the taxpayer. But a substitute method must have the approval of the Tax Commission.

Unincorporated Business Tax and the Statute of Limitations

A New York partnership did business in Chicago. The partnership considered that the activities in Chicago were carried on through a branch office. The New York partnership returns included the income from the Chicago branch office. In preparing the unincorporated business tax return, which is attached to the partnership income tax return, the Chicago income was excluded. A rider was attached to the return stating that the Chicago income was excluded and, since separate accounts were maintained for the Chicago office, none of the Chicago income was allocated to New York. The Tax Commission is questioning the exclusion of the Chicago income from the unincorporated business tax. The Chicago gross income was more than 25% of the gross income reported for unincorporated business tax. One of our members would like to know whether the Tax Commission, in assessing the unincorporated business tax, is limited by the three-year statute of limitations, the five-year statute (more than 25% of the gross income having been omitted), or whether the Commission may assess the tax without any limitation.

In our opinion, the five-year statute would apply. In the case of taxpayers filing an unincorporated business tax return, the three-year statute normally applies under Section 373.1: "* * * the amount of tax due under any return shall be determined by the tax commission within three years after the return was made, * * *." However, the same section further provides that "where there has been omitted from gross income or capital gain as stated in a return, an amount which should have been included therein and which is in excess of 25% of the amount of gross income or capital gain as so stated, the amount of tax due may be determined within five years after the return is filed."

Sec. 386 j of Article 16A, the article that imposes the Unincorporated Business Tax, provides that all the provisions of Article 16, Sec. 373, (the statute of limitations), Sec. 374 (application for revision by a taxpayer) and Sec. 375 (review of a determination of Tax Commission by the Supreme Court), apply in the administration and enforcement of the provisions of Article 16A, "in the same manner as if the language of said sections and subdivisions had been incorporated in full into this article."

Where no unincorporated business tax return is filed the amount of tax due may be assessed and collected at any time. That question arose in the case of *Hewitt* v. *Bates*.[1] In that case, the taxpayer, who ran a private school, had not filed any unincorporated business tax reports, claiming exemption under Sec. 386, which excludes certain professions from the tax. The Tax Commission claimed that since the taxpayer had not filed any separate report as required by the regulations the statute did not run at all. The taxpayer argued that the income tax returns that were filed contained sufficient information to permit computation of the unincorporated business tax and, therefore, the filing of the income tax return started the three-year statute of limitations running for the unincorporated business tax return. The Appellate Division held on that issue for the taxpayer, but the Court of Appeals reversed the lower court. It held that a taxpayer may not ignore the obligation to file a separate return for the unincorporated business tax. The individual income tax is separate and distinct from the unincorporated business tax under Article 16A. The filing of an income tax return is not a compliance with Article 16A to file the unincorporated business tax return.

In the April, 1949, issue of the New York State Tax Clinic (p. 265), we had occasion to discuss the application of the statute of limitations to a case where a taxpayer, in 1943, reported certain income as capital gains and the Tax Commission in 1948 determined that such income should have been taxable as ordinary income. It was our opinion that in that case the three-year statute of limitation applied. That situation we believe differs from the one presented in this discussion.

Dividends on Veterans' Life Insurance Policies

Are the special dividends that will be received by veterans from the Veterans' Administration on National Service Life Insurance policies includible in gross income and thus subject to state income tax? Deputy Commissioner Kassell has just issued an opinion[2] that the special dividends are excluded from gross income. The dividends constitute a reduction of the premiums paid and come within the provisions of Article 39 of the Regulations exempting amounts received as a return of premiums paid under life insurance contracts.

Applications for Revision and Refund

The provisions under the State income tax law with respect to a recom-

[1] 297 N. Y. 239, (1948). See also N. Y. State Tax Clinic, June, 1948, p. 461 and June, 1947, p. 395.

[2] Sept. 29, 1949.

putation of tax and refunds are quite different from the federal law. Within two years from the date of the filing of a return a taxpayer may make an application for revision or refund of the tax. The application for revision or refund must now be made on a form (#113) prescribed by the Tax Commission. Where a tax has been recomputed by the Tax Commission and an assessment issued, the taxpayer may file an application for revision or refund within one year from the date of such recomputation or assessment (Sec. 374).

Upon receipt of the recomputation or assessment the taxpayer may either pay the recomputed tax or not. But he must file the application for revision within one year if he wishes to protest the recomputed tax. If he pays the recomputed tax and then files an application for revision, he must be certain that the application is filed within one year from the date of the recomputation or revision, not one year from the payment of the tax. Under the federal law a taxpayer may file a claim for refund within two years from the date of payment of any tax or within three years from the time the return was filed (Sec. 322 b I.R.C.).

Two cases have come to our attention recently where the taxpayer lost his chance to protest an additional tax because the application for revision was not timely filed. In one case the taxpayer wrote a letter indicating his disagreement with the action taken by the Tax Commission in assessing an additional tax. A year expired and then the taxpayer wished to pay the tax and file an application for refund. The statute of limitations (one year from the date of the recomputation) had expired and the taxpayer was therefore without any remedy. The letter protesting the action of the Tax Commission, while written within the one year period, was not in a form prescribed by the Tax Commission.

In the second case, the Commission had issued an arbitrary assessment. The taxpayer wrote a letter protesting the assessment, but nothing further was done within the year. Thereafter the taxpayer sought the advice of counsel and learned that it was too late to file any formal application for revision. There does not seem to be any procedure in the Tax Law that would give the taxpayer any redress in a situation of this type, but it is our opinion that the Tax Commission would find a way of minimizing a tax based upon an arbitrary assessment if it subsequently was satisfied that the tax was clearly erroneous.

Gross Receipts Tax

This is a New York City excise tax based upon gross receipts of trades, businesses, professions, vocations, or commercial activities carried on in New York City. It was first levied in 1942, when the rate of tax was 1/20 of 1%. In 1946, the rate was increased to 1/10 of 1% and, in 1948, the rate was again increased to 1/5 of 1%. Because the tax is based upon gross receipts, with the rate four times what it was in 1942, this tax is beginning to make appreciable inroads into the income of a business.

The gross receipts tax law covers also the tax on financial businesses carried on in New York City, although in the latter case the tax is based not on gross receipts but on gross income and the rate is 2/5 of 1% on such gross income. This tax was also increased from 1/10 of 1%, the applicable rate in 1942, and 1/5 of 1%, the rate in effect since 1946.

The tax merits closer study on the part of taxpayers and their accountants.

Gross Receipts Tax—Exemptions

No tax is imposed on taxable activities if the gross receipts are under $10,000. That does not mean that each taxable entity receives an exemption of $10,000. If the gross receipts of a business are $9,999.99 there is no tax. All financial businesses are subject to tax on gross income regardless of amount.

Organizations of the type exempt from federal income tax are generally

exempt from the gross receipts tax. The regulations (Art. 107) list such exempt organizations. They include charitable and religious corporations and associations, national banking associations, banks, trust companies, cooperative corporations, fraternal orders, domestic building and loan associations, business leagues, civic leagues, clubs.

Public utility corporations are exempt if they are otherwise taxed on gross income or gross receipts. Receipts from sales of real estate and from rents are specifically exempt (Sec. B46-1.0), as are also wages and salaries of an individual. Receipts are defined in the law as something "received in, or by reason of any sale made or services rendered or commercial or business transaction had in the city * * *." The regulations list no fewer than 18 items that may be excluded from gross receipts. A number of these items should be emphasized: (4) reimbursement of loaned money; (11) outright gifts; (12) bequest and devises; (14) reimbursement of traveling expenses; (15) money received as agent for another person; (18) discounts on purchases. Also excluded are discounts unconditionally deducted by customers, if these discounts are allowed as a matter of established custom without regard to the due date of bills.

Since the tax is based upon gross receipts with no deduction permitted for cost of property sold or cost of materials used or any other costs or expenses, the regulation covering exclusons becomes quite important. Any receipt that can be brought within the eighteen enumerated items as an exclusion will, of course, reduce the tax.

Gross Receipts Tax—Financial Business

The rate of tax on a financial business is double that on other taxable entities, although it is based upon gross income rather than gross receipts. It thus becomes important to determine the classification of a taxpayer, particularly in border-line situations. Private banks, holding companies, factors and commission merchants are considered in the law to be financial businesses. So are dealers and brokers in money, credits, commercial paper, bonds, notes, securities, and stocks. "Where the spread of difference between the cost of goods sold and the sales price is analagous to or in the nature of a commission and does not in any event exceed 3% of the cost of goods sold" a dealer in merchandise is classified as a financial business. The regulations (Art. 301) include under this classification members of the stock exchanges who act as commission brokers, floor brokers, odd-lot dealers and brokers and specialists. Also included are finance companies, investment trusts and pawnbrokers.

It is possible for a taxpayer to come under both classifications. The law (Sec. B46-11.6) gives to the comptroller the power "to determine whether any trade, business, profession, vocation, or commercial activity shall be in whole or in part classified as financial business or otherwise; and in case any trade, business, profession, vocation or commercial activity shall be classified in part as financial business, to set forth the manner of computing the tax hereunder upon *each* part in accordance with such classification."

What Constitutes Doing Taxable Business in New York

We are accustomed to consider the problem of doing taxable business in New York for franchise tax purposes. Foreign corporations and non-residents are aware that they may carry on a certain degree of activity in New York without being subject to franchise tax. Those activities are usually an integral part of interstate commerce and are not deemed localized sufficiently so as to be construed as the doing of intrastate business. For gross receipts tax purposes, however, these foreign corporations and non-residents are subject to different criteria and many of them find

themselves squarely within the gross receipts tax provisions, even though they are not subject to franchise or income taxes.

Generally, any business, professional or commercial activity carried on within the city subjects the taxpayer to tax. The regulations (Art. 106) enumerate five activities that are construed as subjecting the taxpayer to the gross receipts tax. These are as follows: The maintenance of an office or other place of business within the city from which the taxpayer (a) sells or delivers tangible personal property; (b) solicits or procures sales orders for the delivery of tangible personal property to persons within the city; (c) engages in processing or manufacturing activities; (d) renders services or executes or performs contracts; (e) solicits or procures orders for the rendition of services to persons within the city.

The regular maintenance of a stock of goods within the city, either at a public warehouse within the city or at a private storage place or in moving vehicles from which deliveries are made, is the doing of business which is considered as taxable activity.

"If a foreign corporation maintains an office within the City of New York at which are controlled in whole or in part the management and internal affairs of the company, where meetings of stockholders or directors are held, or where the corporate books and records are kept, or where dividends are voted or paid, or where officers are elected, or where contracts are executed or accepted, such corporation is deemed to be doing business within the City of New York so as to be subject to tax * * *."

The extent to which the law is deemed to cover a foreign corporation is seen from another provision in Article 106. The law subjects to tax any out-of-city business even if it makes sales to persons within the city through a sales representative, an independent sales agency, a resident salesman, or in any other manner. Sales made through a "del credere" agent are not taxable as to such sales. That is an exception which was included in the regulations on January 3, 1947. The fact that the sales representative is an independent contractor or acts on behalf of other vendors, does not affect the taxability of the out-of-city business.

Because the law recognizes that it may not or should not tax interstate activities, such receipts are allocated to determine the portion attributable to city activities.

Allocation of Receipts from Interstate Commerce

The law (Sec. B 46-2.0(b)) states clearly that where a receipt cannot be subjected to the tax in its entirety because of the provisions of the United States Constitution (the interstate commerce clause), the Comptroller is empowered to establish methods of allocation in order to determine the part of the receipt that is properly attributable to the doing of business in the city and therefore taxable. The law enumerates some of the methods of allocation that may be made. Included are a method based upon mileage; division of the receipt according to the number of jurisdictions in which it may be taxed; the ratio of the value of the property or assets owned and situated in the city to the total property or assets wherever owned; and/or any other methods of allocation "calculated to effect a fair and proper allocation in accordance with the purposes of this subdivision."

The regulations (Art. 209) start off with the statement that receipts from transactions involving interstate commerce are to be included in the basis of the tax either in their entirety or upon an allocated basis.

In determining whether a transaction involves interstate commerce, it is of no importance where title passes or whether the goods are shipped f.o.b. one state or another.

A sale made by a New York City vendor to customers located outside the State of New York, where the property is delivered directly to the purchaser or his agent within New York State, is not deemed to involve interstate commerce even if the purchaser transports the property to a point outside the state. The sale does involve interstate commerce if the New York City vendor delivers the goods to the purchaser outside the state or to a common carrier for shipment to the purchaser at a point outside the state.

Likewise, a sales does not involve interstate commerce if the purchaser maintains an office, warehouse, or receiving station within the city for the purpose of receiving, inspecting, routing, or combining shipments destined for out-of-state places of business. This is true even though goods are delivered to such premises and thereafter actually transported to a point outside the state. An exception is made where goods are delivered to a "packing company."

A sale made by a New York City vendor, where goods are specifically to be shipped from a factory or warehouse located outside the state directly to the purchaser at a point within the City, is one made in interstate commerce. If the factory or warehouse is not owned or operated by the vendor the sale is not made in interstate commerce. Also, if the goods are first shipped to the vendor's place of business in New York City and then delivered to the purchaser, the sale is deemed not to involve interstate commerce.

These distinctions may seem to be finely spun, but they spell the difference between a taxable receipt and a nontaxable or partly taxable one. In that connection, we are reminded of the Supreme Court decision in *McGoldrick* v. *Berwind White Coal Mining Co.*,[3] which upheld the constitutionality of the New York City Retail Sales Tax which taxed the sale of coal moving from outside the state into the city, pursuant to a contract entered into in the city.

It should be noted that persons who are engaged in a profession or in rendering personal services, who maintain offices only within the city and perform part of their work outside the state of New York, are subject to tax on their entire gross receipts. If they maintain offices outside the city the receipts may be segregated.

Art. 230 of the regulations permits persons engaged in the business of editing, printing, and publishing newspapers or other publications to allocate receipts from the distribution of the publication outside the state. Distribution within the state is not allocable, but the allocation is permitted even though the taxpayer has only a local place of business. Receipts from the sale of advertising space are not deemed to constitute interstate commerce. If the main office of the publisher is situated within New York City, the entire receipts are wholly taxable. Where bona fide branch officies are maintained outside the city of New York for the solicitation and procurement of advertising contracts, a deduction from gross receipts may be made for advertising contracts solicited or procured by officers and employees working from or attached to such bona fide branch offices (Art. 231). It should be noted further that no deduction may be taken for agency commissions.

Gross Receipts Tax—Foreign Commerce

Transactions in foreign commerce are non-taxable but must be reported. The old original package rule applies to receipts from the sale of imports by the importer. The receipt is a sale in foreign commerce if sold in the original unbroken package or container even if, at the time of sale, the goods are located within the city and even if both the seller and the buyer are within the city.

The receipt is taxable if the importer does not sell the goods in the original package and the reciept is also taxable

[3] 309 U. S. 33 (1940).

when the goods are sold by by any person other than the importer. In this type of receipt there is also the problem of what constitutes the original package. Art. 207 cites one illustration of cigarettes imported from Cuba. The cigarettes are packed in small boxes of 20 each and are packaged in cartons containing ten boxes. The cartons are placed in large packing cases containing 200 cartons. In this illustration the original package is the large packing case. Thus if the importer breaks the overall package and sells any portion of the contents, the receipts would then be taxable.

Receipts from the sale of goods exported from the United States are also sales in foreign commerce and deductible from gross receipts. Delivery to a common carrier for subsequent delivery to the buyer at a foreign destination involves foreign commerce. The place where title passes is immaterial. But stevedoring operations carried on entirely within the city of New York do not constitute foreign commerce and steamship companies or agencies that book freight and passenger business are taxable on their gross receipts. If the latter companies maintain offices within and without the city of New York, the receipts are segregated and only an allocable portion is attributed to New York City.

Further comments on the Gross Receipts tax will appear in subsequent issues.

Disability Benefits Law

In the October issue of the Tax Clinic,[4] there appeared a general discussion of the new Disability Benefits Law which was passed in April, 1949. Under date of October 15, 1949, the State of New York issued a bulletin, under the imprint of the Workmen's Compensation Board, containing the text of the law and an outline of the major provisions of the law. With the bulletin came a letter signed by Mary Donlon, Chairman of the Workmen's Compensation Board, addressed to the New York State employers, highlighting important information about the law. The introduction to the bulletin indicates that regulations will be issued in due course.

It is estimated that about 170,000 employers of four or more, and about six million employees, will come within the provisions of the law. Those employers who intend to provide for payments of benefits through insurance with insurance companies are not required to do so until July 1, 1950.

From January 1, 1950, to June 30, 1950, a temporary six-months assessment will be levied against both employers and employees, to accumulate funds to pay benefits to the disabled unemployed. During this period contributions will be at the rate of 2/10 of 1% on wages of all covered employees, one-half by the employee and one-half by the employer. The maximum contribution by the employee is six cents, which means a contribution at the rate of 1/10 of 1% on the first $60 of weekly wages. The employer will match this amount for each employee.

The permanent contributions will commence on July 1, 1950, and for the employee this will be at the rate of ½ of 1% on the first $60 of weekly wages. The employer will use this contribution and add to it enough of his own funds to pay for the cost of providing the disability benefits. The employer's contribution will probably amount to as much as each employee contributes.

Disability Benefits Law—Proposed Regulations

A public hearing was held on October 20, 1949, to discuss proposed regulations on several of the provisions of the new Disability Benefits Law.[5] The proposed regulations define the term "employee" to include all those who

[4] Page 649.

[5] Chapter 600 of the Laws of 1949, constituting Article 9 of the New York Workmen's Compensation Law.

come within the legal relationship of employer and employee in all employment covered by the law. That includes superintendents, managers, administrative personnel and officers of a corporation, except nominal officers. A director who acts only as a director is not an employee. The law excludes from coverage a spouse or a minor child, and a minister, priest, rabbi or member of a religious order.

If an individual employer engages in two or more unrelated types of business, each business is deemed to be a separate employment. However, the entire business of a partnership or corporation is deemed to be a single employment.

Domestic service is covered in the law if the employer has four or more employees on each of at least thirty days in any calendar year. Domestic service includes, without limitation, service as a cook, laundress, cleaning woman, maid, gardener, handyman, chauffeur or valet.

Casual employment and the first forty-five days of extra employment of employees not regularly in employment are not covered by the law. The regulations say that this applies to employees who work for limited special periods and who are not regularly in the labor market. The forty-five day requirement refers to services for a single employer during an employment period, which means a period of twelve months. The determination of whether an employee is attached to the labor market will depend upon past work record, registration at a labor employment office, frequency and regularity of application for employment and other circumstances.

Labor or services not in the regular and usual course of the employer's business but rather occasional or incidental is construed as casual employment and is not covered by the law. But if the employment recurs frequently and is characteristic of the employer's usual conduct of the business the employment is not casual. Temporary employment for a temporary period of one regularly in the labor market is not exempt.

If the employee's base of operations is in New York, or the place from which his services are directed is in New York, the employee is covered even though some of the services are performed in another state.

The burden of proof is upon the employer to show that any employment is exempt from the provisions of the law.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Change of Editors

With this issue, the responsibility for the work of this department passes from the supervision of Mr. William W. Werntz to that of Mr. Louis H. Rappaport. We acknowledge gratefully the splendid work of Mr. Werntz, curtailed solely by reason of the pressure of increasing activities and responsibilities. We welcome Mr. Rappaport to his new role of editor, and feel certain that with his many years of diversified and responsible experience in this specialized area, he will continue to provide our readers with expert coverage of accounting activities under the S.E.C.

Emanuel Saxe, *Editor*

Proposed Revision of Regulation S-X

A preliminary draft of a proposed revision of Regulation S-X was recently sent by the SEC to a number of people with a request for comments. This regulation is the principal accounting regulation under the various statutes administered by the Commission. In the hope of issuing the revised regulation before the year-end, the Commission asked for comments on its proposal before November 1, 1949.

The proposed revision relates to Articles 1 to 5, inclusive, and contains a number of new and controversial statements on accounting principles. It is believed that some of these statements may have been put forth with the purpose of obtaining readers' reactions, and it is quite likely that some or all of the more controversial statements will not find their way into the final revision or will be modified in the revision. We understand that a new draft of the proposal is now in preparation and, like the first draft, will be circulated for comments prior to adoption by the Commission. It is expected that the new draft will be ready around the end of November, 1949, and will be sent to all persons on the mailing list.

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a member of the Society's Committee on SEC Accounting as well as the Committee on Foreign Trade Accounting.

Mr. Rappaport was graduated from Columbia University in 1930, and is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's. He is a member of the American Institute of Accountants and of the American Accounting Association.

SEC Adopts One New Form and Revises Three Existing Forms

The Securities and Exchange Commission has announced the adoption of a new form and the revision of three existing forms under the Securities Exchange Act of 1934.

Adoption of Form 9-K: The new form is for quarterly reports and is designated Form 9-K. It replaces Item 11 of Form 8-K as heretofore in effect, which item deals with quarterly reports of sales and operating revenues. The new form does not make any substantial change in the reporting requirements of Item 11. The effect of this action is merely to put quarterly reports of sales and operating revenues in a separate re-

port form, rather than use Form 8-K which now becomes a current report to be filed only if certain designated events occur. Form 9-K need not be filed by insurance companies, investment companies, common carriers, public utilities, or any company primarily engaged in the production and sale of a seasonal single-crop agricultural commodity.

Revision of Form 10: Form 10, application for registration of securities on a national securities exchange, has been revised. The revised form replaces the present Form 10 and also the following forms: Form 7 for provisional registration, Form 11 for unincorporated issuers, Form 13 for insurance companies, Form 15 for incorporated investment companies, Form 17 for unincorporated investment companies, Form 22 for reorganized issuers, Form 23 for successor issuers, and Form 24 for bank holding companies.

Among the more important changes made in the revised form are the amplification of the items and instructions calling for a description of business and property, the disclosure of material litigation, and the amendment of the remuneration items to bring them into line with the proxy rules.

The instructions as to financial statements have been expanded to require, in addition to the present requirements, information as to 50% owned companies, affiliates whose securities secure an issue being registered, companies in reorganization or succession, and businesses acquired or to be acquired. There are also special instructions for companies that are not in the production stage and a general provision permitting the filing of other statements in certain cases where the required statements are inadequate or inappropriate. As a result of these revised instructions, the statements required in Form 10 are generally the same as those under Form S-1 (under the 1933 Act) except that the requirements in the latter form regarding the date of the latest statements (within 90 days of filing in some cases, within 6 months in others) do not apply to Form 10.

Another change in Form 10 is the reduction in the period covered by the item dealing with Historical Financial Information. Here also the revision is in the direction of making the requirements of Form 10 similar to those of Form S-1. Previously this information was required beginning with the year 1925; now it need cover only the seven years preceding the period covered by the income statement.

Revision of Form 10-K: A number of changes have been made in the narrative section as well as in the financial section of Form 10-K, which is the form of annual report filed with the SEC and the stock exchanges by companies having securities listed on the exchanges.

The revised Form 10-K replaces the present Form 10-K and will also be used by unincorporated issuers that now use Form 11-K, insurance companies that now use Form 13-K, bank holding companies that now use Form 24-K, and certain unlisted companies that registered securities under the 1933 Act and are required to file annual reports on Form 1-MD.

The item dealing with material changes during the year in the general character of the business has been expanded to elicit more information as to important changes which have occurred. The remuneration items have been changed substantially along the lines of the corresponding items in the proxy rules.

The revised Form 10-K contains new items calling for information as to important changes in physical property of the issuer and its subsidiaries and information with re-

spect to materially important strikes, legal proceedings, or important developments in such proceedings. Deletion has been made of items with respect to description of new and modified securities and contracts and other exhibits since this information will be reported in the revised 8-K (see below).

The changes in requirements for financial statements are similar to those in Form 10 as revised and in other forms, except that, Form 10-K being an annual report form, the financial statements cover only one year.

Form 8-K: This is the form that is prescribed for current reports and it must be filed within ten days after the end of any month during which any one or more of certain specified events occur. The form has been revised to broaden its scope so as to require information with respect to certain matters in addition to those presently required to be reported.

Item 11 of the prior Form 8-K, dealing with quarterly reports of sales and operating revenues, will hereafter be reported on a separate form (Form 9-K).

The more important new items covered by the revision of Form 8-K are those dealing with the following: revaluation of assets; the acquisition or disposal of a substantial amount of assets; the institution or termination of important litigation; guaranteeing securities of other issuers; defaults upon senior securities and the institution of bonus, profit sharing, pension and retirement plans.

The Commission's actions are now in effect but the old forms may be used for applications and reports filed during the remainder of 1949. Beginning on January 1, 1950 the new and revised forms must be used.

The Shoptalkers

Conducted by Lewis Gluick, C.P.A.

Jump on Conclusion-Jumpers

"And the Shoptalker will have his usual poached egg on spinach, *au gratin,*" said the Kid, as the waitress took his order.

"And the Shoptalker is going to have nothing of the kind," retorted the Shoptalker, as he ordered a vegetable salad with tomato aspic. "This summery weather calls for something cool. And of all people who shouldn't jump at conclusions, a C.P.A. is the chief one."

"And what a day on which to talk about conclusion jumping!" exclaimed Oldtimer. "Columbus jumped to the conclusion that he had reached India."

"He was no accountant," said Philo. "Just as the Shoptalker says, no C.P.A. should jump at conclusions. Yet I defy anyone here to say truthfully that he has never done so,—and paid for it."

"Hit; no change!" yelled Sinbad, "And I want to be the first to confess. Way back in 1918 I sounded an alarm for a floating mine which turned out to be nothing but a 40 gallon steam kettle. And to this day any of my then shipmates greet me with 'MINES'."

"Sure," said the Kid. "And I have a neighbor who thought I never changed my walking shorts, never dreaming that I could have two identical pairs."

"Come, come," said Oldtimer. "Don't evade the issue. This experience meeting is to tell about *our own* false jumps in our profession. Maybe I'd better illustrate."

"Floor is yours," said Philo, and the rest chorused, "Go on."

"This happened many years ago, but I was old enough to have known better. I went off on a new engagement, and found that the junior assigned to the job by the chief of staff was a stupid looking youngster; and what's more the client pointed it out to me. 'Fifteen dollars a day for THAT,' he said. I asked the senior on the job about the boy, and he told me it was adenoids; the boy had quit college and taken the job in order to earn enough money to pay for the operation. No charity for him. I liked his spirit, but to mollify the client 'phoned the chief to send around a new boy the next day. Then I had to countermand the order; client wouldn't let me. The stupid looking kid had found an error of great importance; could have cost the client twelve thousand dollars. Nothing brilliant about it; routine audit, and all that. But it proved the kid was wide awake, and following his instructions."

"Me next," said the Kid. "I really got my start by another man's jumping to a false conclusion about me. Was assigned to work with the most junior of several partners, a man who was disliked by all the staff. He put me to taking off a trial balance of what still is the biggest general ledger I've ever seen. It would take an hour to describe it. I'd had less than six months' experience, but I dug in, and at the end of the day had all the accounts listed, and the totals did not balance. I tried to check myself by use of one of the client's adding machines, and the sunuvagun ordered me off. An accountant, a real accountant, didn't use a machine. So I struggled till the client closed shop, and was still way out. Next morning I was

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Lewis Gluick, C.P.A., who has been a member of our Society since 1924, has resumed the practice of accountancy in the East.

Mr. Gluick, who had been writing under the name of The Shoptalker in other magazines since 1928, recently brought his group of Shoptalkers to our columns. We would welcome your acceptance of his invitation to participate in the discussions.

hauled on the carpet, before the senior partner and the chief of staff, accused of incompetence, and fired. A much more experienced man was then put on the job; and it took *him* two solid days to find all the errors, *in the books,* not my take-off. The junior partner had jumped to the conclusion of my incompetence because it was the first time in years that the client's bookkeeper had not proved his trial balance before the arrival of the auditors."

"I know the rest of that story," said Oldtimer. "Two hours after being fired, an agency sent you to my firm, and I hired you. And that was one good conclusion that I did jump to."

"And at five bucks a week more than I'd been getting, too!" said the Kid, while the table laughed.

"Accountants are not the only men who must not jump to conclusions," said Law. "Right now I'm trying to defend a physician who made a wrong, and nearly fatal, diagnosis. And I jumped in feet first in a tax case some time back. Want to hear about it?" There was a mumur of assent.

"It was family partnership case. I can't say I really jumped blindfold. I really did do some digging, and had a clerk check my cites. My jump was in not looking at the pending case list in the Supreme Court docket. Had I done so I might have contrived a delay in settlement until the *Culbertson* case was decided. As it was, I concluded that the client didn't have a case, and recommended payment to avoid further penalties and interest. Now, in the light of the *Culbertson* decision, and the ones the lower courts have been handing down in compliance therewith, I see I was wrong. And I'm digging like mad to see if it is too late to sue in Court of Claims, and whether a closing agreement is binding under such circumstances."

"If you ever find out," said the Shoptalker, "Let us know. Better still, write an article about it, and everybody will get the benefit."

"Anything to offer for the good of the order, Star?" queried Oldtimer.

"You bet; and this is a lulu. Only I wasn't kicked upstairs like the Kid. When I was fired, I stayed fired. That's how I came to go into practice for myself. Haven't done too badly, but it was a darn expensive lesson. I had the utmost respect for the partners for whom I worked. And when one of them gave me a depreciation schedule which he had not quite completed, and told me to finish it, I merely finished it. I jumped to the conclusion that the king could do no wrong, and never checked his figures. The report went out that way. Believe it or not, the junior who read the proof saw the work sheet almost all in the boss's handwriting, and merely read copy; checked only my few computations. It was almost three years before a revenue agent brought the bust to light; the client had to pay an additional assessment; and even though the firm paid the interest, the firm lost that client, and I lost a good job."

"Look," said Dash. "If any of you are in a hurry, get out. My yarn is a long one."

"Don't mind us," said the Kid. "As long as the Shoptalker is around, you'll have an audience."

"This was what you might call a triple jump. First of all, the firm I worked for jumped to the conclusion that, the client having been audited annually for several years, the books would be in good order. So instead of sending a top senior in at the start, a couple of good semi-seniors were sent around to start the audit, with the senior to follow when he was available. It was a fiscal year audit; vacations were still on; and some summer tax work had cropped up unexpectedly. Well, the boys tried to follow the program and preceding working papers, but ran into a stymie. They jumped to the conclusion they could find the trouble unassisted, and thereby gain much kudos. Instead, by the time I got there, at the end of two weeks, they still hadn't balanced the accounts receivable,

the chief asset, and the time charged in was all the fee could take without a loss. I reported back to the senior partner and he, always a nervous type, jumped on everybody. The chief of staff for assigning the boys; for not assigning me sooner; and me for not finding the whole trouble in an hour. The usual rigamarole of 'You're a N.Y. CPA. You shouldn't let boy's work bother you.' But eventually he came to the client's office, and after an hour's grumbling, *he* took off his coat and joined in the work. To make a long, sad story short, it took another week to prove a shortage of a thousand dollars in the cash, all through the receivables; and what was more, we uncovered what looked like a marvelous scheme for getting fourteen thousand more. I dare not repeat the details even now; dangerous to get them in print (with a glance at the Shoptalker), but we scotched it. The general manager had jumped to the conclusion that our audit would end with the reconciliation of the bank accounts at the end of the month following the balance sheet date. That's the way it always ended. But due to the delays in making the audit, both start and progress, I reconciled the accounts for another month, during which he had juggled funds from one account to another, apparently preparing for a getaway as soon as the audit was completed. He would have too, but for the preceding delays. The firm lost heavily on the engagement. Chargeable time was double the fee, but I think they're even by now. For the experience proved to the client that an annual audit was not practical, and a quarterly general audit, with surprise cash audit and bank reconciliations at least every two months, was substituted."

Everybody got up and left but the Shoptalker and Sinbad, and off the record Dash told them about the scheme that failed. It *should be* off the record.

* * * * *

We thank M. M. Spencer for his comments on the Wezee Corp. problem (October issue).

"A net worth statement, correct both from the accounting and the tax points of view, would be

Capital stock, 1,000 shares @ par	$ 100,000.00
Paid in surplus	3,750.00
Earned surplus	996,250.00*
Total	$1,100,000.00
Less treasury stock, 500 shares, at cost	550,000.00
Net worth	$ 550,000.00

* To be reduced by tax liability on $240,000.00 gain.

"The sale of realty comes within the 117J classification to the corporation, even if the realty is deemed not a capital asset.

"The big danger in the deal is that the gain to Walter and Yerkes on the sale of their stock may be construed by the Commissioner as 'essentially equivalent to the distribution of a taxable dividend'. The taxpayers in this instance have a good case against such a construction, but they may have to go through prolonged controversy and litigation to prove their point."

MERRY CHRISTMAS TO ALL. MAKE IT A MERRIER ONE BY BUYING LOTS OF ANTI-TUBERCULOSIS SEALS — AND USING THEM!

OFFICIAL DECISIONS *and* RELEASES

ACCOUNTING RESEARCH BULLETINS

Issued by the
COMMITTEE ON ACCOUNTING PROCEDURE,
AMERICAN INSTITUTE OF ACCOUNTANTS,
270 Madison Avenue, New York 16, N. Y.

No. 38 **October, 1949**

Disclosure of Long-Term Leases in Financial Statements of Lessees

1. The growth in recent years of the practice of using long-term leases as a method of financing has created problems of disclosure in financial statements. In buy-build-sell-and-lease transactions, the purchaser of land builds to his own specifications, sells the improved property, and simultaneously leases the property for a period of years. Similar transactions are the sale and lease of existing properties or the lease of properties to be constructed by the lessor to the specifications of the lessee. The lessee ordinarily assumes all the costs and obligations of ownership (such as taxes, insurance, maintenance and repairs) except for payment of any mortgage indebtedness on the property.

2. There are many variations in such types of transactions. For example, some leases contain an *option* for acquisition of the property by the lessee, while other leases contain a *requirement* that the lessee purchase the property upon expiration. In some the price to be paid upon repurchase is related to the fair value of the property or the depreciated book value; in others it is an arbitrary amount with little or no relation to the property's worth, or a nominal sum. Some leases provide for a high initial rental with declining payments thereafter or for renewal at substantially reduced rentals.

3. It has not been the usual practice for companies renting property to disclose in financial statements either the existence of leases or the annual rentals thereunder.[1] One of the effects of the long-term lease as a substitute for ownership and mortgage borrowing is that neither the assest nor any indebtedness in connection with it is shown on the balance-sheet. This has raised the question of disclosure in financial statements of the fixed amounts payable annually thereunder.

4. Although the types of sell-and-lease arrangements referred to in paragraph 1 differ in many respects from the conventional long-term lease,[2] the principles of disclosure stated herein are intended to apply to both. This bulletin does not apply to short-term leases, or to those customarily used for oil and gas properties.

5. The committee believes that material amounts of fixed rentals and other liabilities maturing in future years under long-term leases and possible related contingencies are material facts affecting judgments based on the financial statements of a corporation; and that those who rely upon financial statements are entitled to know of the existence of such leases and the extent of the obligations thereunder, irrespective of whether the leases are considered to be advantageous or otherwise. Accordingly, where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:

(a) discloure should be made in financial statements or in notes thereto of

(1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable, and

(2) any other important obligation assumed or guarantee made in connection therewith;

(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.

6. A lease arrangement is sometimes, in substance, no more than an installment purchase of the property. This may well be the case when the lease is made subject to purchase of the property for a nominal sum or for an amount substantially less than the prospective fair value of the property; or when the agreement stipulates that the rental

[1] The Securities and Exchange Commission, however, in Note 5 to Rule 12-16 of Regulation S-X dealing with supplementary profit and loss information, requires disclosure in a schedule, if significant in amount, of ". . . the aggregate annual amount of the rentals upon all real property now leased to the person and its subsidiaries for terms expiring more than three years after the date of filing, and the number of such leases," and the minimum annual amount if the rentals are conditional.

[2] The conventional lease, a straight tenure contract between the owner of property and a lessee, generally does not involve buying, building and selling of property by the lessee, or special repurchase arrangements.

payments may be applied in part as installments on the purchase price; or when the rentals obviously are so out of line with rentals for similar properties as to negative the representation that the rental payments are for current use of the property and to create the presumption that portions of such rentals are partial payments under a purchase plan.

7. Since the lessee in such cases does not have legal title to the property and does not necessarily assume any direct mortgage obligation, it has been argued that any balance-sheet including the property as an asset and any related indebtedness as a liability would be incorrect. However, the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, then the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

The statement entitled "Disclosure of Long-Term Leases in Financial Statements of Lessees" was unanimously adopted by the twenty-one members of the committee.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

COMMITTEE ON ACCOUNTING PROCEDURE (1948-1949)

SAMUEL J. BROAD, *Chairman*	ANSON HERRICK	MAURICE E. PELOUBET
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J. P. FRIEDMAN	WILLIAM A. PATON	*Director of Research*

No. 39 **October, 1949**

Recommendation of Subcommittee on Terminology

Discontinuance of the Use of the Term "Surplus"

Foreword

The committee on accounting procedure has approved as an objective the recommendation of the subcommittee on terminology made herein with respect to the discontinuance of the use of the term "surplus" in accounting, and has authorized its publication. The statements herein contained, however, are not to be regarded as pronouncements of the committee on accounting procedure.

Recommendation of Subcommittee on Terminology

In a report of the committee on terminology, issued in September, 1941, as Research Bulletin No. 12 (Special), it was recommended that consideration be given to the feasibility of a general discontinuance of the use of the word *surplus* in accounting. Since that time there has been extensive discussion of the proposal, and some companies have used other terms in their financial statements. The present subcommittee on terminology of the committee on accounting procedure has considered the matter and its conclusions are set forth herein.

A factor of primary importance in the balance-sheet presentation of the stockholders' equity is the status of ownership at the balance-sheet date. Where two or more classes of stockholders are involved, the interests of each must be presented as clearly as possible. These interests include the entire proprietary capital of the enterprise, which is conventionally divided further, largely on the basis of source, as follows:

1. Capital stock, representing the par or stated value of the shares.[1]

[1] In some states the term "capital stock" has been replaced by the term "stated capital" which represents the par or stated value of shares, or the consideration received upon the issuance of shares.

2. Capital surplus, representing (a) capital contributed for shares in excess of their par or stated value,[2] or (b) capital contributed other than for shares.
3. Earned surplus, representing accumulated earnings or the remainder of such earnings at the balance-sheet date.

While the terms *capital surplus* and *earned surplus* have been widely used, they are open to serious objection.

1. The term *surplus* has a connotation of excess, overplus, residue or "that which remains when use or need is satisfied" (Webster), whereas no such meaning is intended where the term is used in accounting.
2. The terms *capital* and *surplus* have established meanings in other fields, such as economics and law, which are not in accordance with the concepts which the accountant seeks to express in using those terms.
3. The use of the term *capital surplus* (or as it is sometimes called, *paid-in surplus*) gives rise to confusion. If the term *surplus* is intended to indicate capital accumulated by the retention of earnings, i.e., retained income, it is not properly used in the term *capital surplus*. Further, if the term *surplus* is intended to indicate a portion of the capital, there is an element of redundancy in the term *capital surplus*.
4. If the term *capital stock* (and in some states the term *capital surplus*) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication in the terms *surplus* or *earned surplus* of availability for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as a practical matter, or as a matter of prudent management, "available for dividends."

It seems highly desirable, therefore, that an effort be made to find terms more nearly connotative of the ideas which are sought to be expressed.

In seeking such terms consideration should be given primarily to the *sources* from which the proprietary capital was derived. In addition regard should be had for certain types of events which may have occurred in the history of the corporation. Thus a quasi-reorganization in which a "new start" has been made, may be said to have put the entire net assets, as restated at the time, into the status of contributed capital, while that part of capital now conventionally described as *earned surplus* would include only earnings retained thereafter and would be "dated" accordingly. Likewise a stock dividend, or a transfer by resolution of the board of directors, must be dealt with as a transfer of capital accumulated by retention of earnings to the category of restricted capital for purposes of subsequent presentation. Finally, the classification of proprietary capital involves a consideration of present status in such matters as contractual commitments, dividend restrictions and appropriations of various kinds.

Recommendation

In view of the foregoing the subcommittee recommends that, in the balance-sheet presentation of the stockholders' equity:

1. The use of the term *surplus* (whether standing alone or in such combination as *capital surplus, paid-in surplus, earned surplus, appraisal surplus*, etc.) be discontinued.
2. The contributed portion of proprietary capital be shown as:
   (a) Capital contributed for, or assigned to, shares, to the extent of the par or stated value of each class of shares presently outstanding.
   (b) Capital contributed for, or assigned to, shares in excess of such par or stated value (whether as a result of original issue of shares at amounts in excess of their then par or stated value, reduction in par or stated value of shares after issuance, or transactions by the corporation in its own shares), and capital received other than for shares, whether from shareholders or others.
3. The term *earned surplus* be replaced by terms which will indicate source, such as *retained income, retained earnings, accumulated earnings,* or *earnings retained for use in the business.* In the case of a deficit, the amount will be shown as a deduction from contributed capital with appropriate description.
4. In connection with 2(b) and 3 there should, so far as practicable, be an indication of the extent to which the amounts have been appropriated or are restricted as to withdrawal. Retained income appropriated as a reserve nevertheless remains part of retained income, and any reserves which are clearly appropriations or segregations of retained income, such as reserves for general contingencies, possible future inventory losses, sinking fund, etc., should be included as part of the stockholders' equity.
5. Where there has been a quasi-reorganization, retained income should thereafter be "dated," and where, as a result of a stock dividend or a transfer by resolu-

[2] This classification includes such items as capital transferred from capital stock account as a result of the reduction of par or stated value, and credits resulting from transactions in the corporation's own stock.

tion of the board of directors from unrestricted to restricted capital, the amount of retained income has been reduced, the presentation thereafter should indicate that the amount shown is the remainder after such transfers.

6. Any appreciation included in the stockholders' equity other than as a result of a quasi-reorganization should be designated by such terms as *excess of appraised or fair value of fixed assets over cost* or *appreciation of fixed assets.*

SUBCOMMITTEE ON TERMINOLOGY

JAMES L. DOHR, *Chairman*
FREDERICK B. ANDREWS
WILLIAM H. BELL

THE NEW YORK LAW JOURNAL WEDNESDAY, NOVEMBER 2, 1949
Page 1088

Ethical Queries and Answers

The committee on professional ethics of the New York County Lawyers Association has recently considered and answered the ethical query following:

QUESTION

Is it professionally proper for AC and BC, two brothers, who are both members of the New York Bar and also certified public accountants of the State of New York, to practice accountancy at the same office, in New York City where they practice law, placing on their office door the following legends:

C & C
Attorneys and Counselors at Law

C & Company
Certified Public Accountants

ANSWER

Two principles are involved in the consideration of this question. The first, grounded on canon 27, is that an attorney at law, acting as such, may not by any form or medium of advertising, announce to the public at large that he has a special skill in a particular branch of the law. This prohibition extends to every type of publicity, including legends on office doors, stationery, announcements, letters, circulars, etc.

The other principle, also established by canon 27, is that a lawyer may not solicit professional employment by advertisements, circulars or by personal communications or interviews not warranted by personal relations.

We are aware that the committee on professional ethics and grievances of the American Bar Association, in its opinion 272 (October 25, 1946), expressed the view that a lawyer could not, as a practical matter, carry on an independent accounting business from his law office without violating canon 27. With all due respect to the committee on professional ethics and grievances of the American Bar Association, we have come to the conclusion that neither of the aforesaid prohibitions of canon 27 would be violated by the procedure set forth in the question, provided that AC and BC, in the practice of their profession as certified public accountants, adhere to the professional standards applicable to attorneys at law with respect to advertising and solicitation. In our opinion the proposed legends on the office door would merely identify the firms occupying the premises and the professions practiced by them therein, and would not constitute either advertising or solicitation by AC and BC within the meaning of canon 27.

The New York Certified Public Accountant

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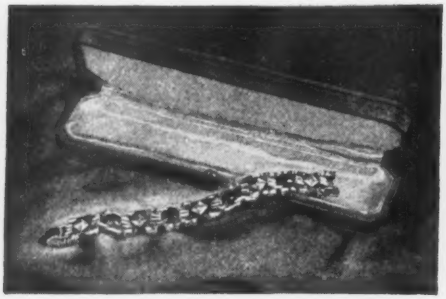

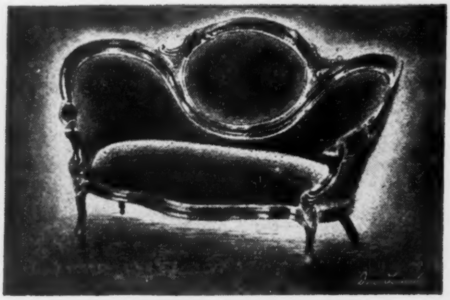

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